A Legislator's Guide to Taxation in Virginia

Volume 1: State Taxes

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DIVISION OF LEGISLATIVE SERVICES

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INVOLVES THE POWER TO DESTROY.

John Marshall 1819

THE POWER TO TAX
IS NOT THE POWER TO DESTROY
WHILE THIS COURT SITS.

Oliver Wendell Holmes, Jr. 1928

A Guide to This Volume

The power to tax, destructive or not, has been exercised in the Commonwealth of Virginia since the poll tax (four pounds of tobacco) in 1639. A glance at the number of chapters in this volume should demonstrate that taxation has grown substantially since Middlesex County, in 1912, submitted $30 in individual income taxes to the Commonwealth.

This report examines the major general fund taxes administered by the Virginia Department of Taxation; the gross receipts premium tax imposed on insurance companies and the gross receipts tax imposed on public service corporations, both of which are administered by the State Corporation Commission; and the motor fuels and titling taxes administered by the Department of Motor Vehicles. The goal is to provide legislators with an easy reference to the major taxes imposed by the Commonwealth. These taxes constitute the vast majority of the Commonwealth's general fund.

In each of the following 11 chapters devoted to a particular tax a basic structure is followed: (i) a brief history of the tax; (ii) a description of the current structure of the tax; (iii) a discussion of how the tax is administered; (iv) the importance of the tax to the Commonwealth's revenue stream; (v) a comparison of Virginia's version of the tax with that of neighboring states and, in many chapters, with all of the other states; (vi) a discussion of the issues that have been raised in the past and are likely to be raised in the future regarding the tax; and (vii) a brief, boxed summary on the final page of the chapter. Individual variations necessarily exist from chapter to chapter, but all adhere basically to the above outline. Chapter 9 examines current enforcement and collection procedures for the taxes administered by the Department of Taxation.

Virginia is a relatively large and wealthy state with a large variety of taxes used to finance the essential functions of state government. This Legislator's Guide to State Taxation in Virginia is an attempt to provide a clear, organized, and concise explanation of Virginia's major taxes to assist the legislator in dealing with the complex taxation issues facing the Commonwealth now and in the future.

Overview of Virginia Taxation

Population

Virginia's population, according to the 2000 Census, was 7,078,515, which placed Virginia 12th in the country by population, the same ranking as in 1990. Table 1 provides a listing of the most populous states based on the 2000 U.S. Census. Of the other southern states, Texas is second, Florida is fourth, and Georgia and North Carolina are ranked 10th and 11th respectively, Tennessee is 16th and Maryland is 19th.

TABLE 1
2000 U.S. Census Population, by State

Rank	State	2000 Population
1	California	33,871,648
2	Texas	20,851,820
3	New York	18,976,457
4	Florida	15,982,378
5	Illinois	12,419,293
6	Pennsylvania	12,281,054
7	Ohio	11,353,140
8	Michigan	9,938,444
9	New Jersey	8,414,350
10	Georgia	8,186,453
11	North Carolina	8,049,313
12	**VIRGINIA**	**7,078,515**
13	Massachusetts	6,349,097
14	Indiana	6,080,485
15	Washington	5,894,121
16	Tennessee	5,689,283
17	Missouri	5,595,211
18	Wisconsin	5,363,675
19	Maryland	5,296,486
20	Arizona	5,130,632

SOURCE: U.S. Census Bureau, U.S. Department of Commerce.

Personal Income

Not only a relatively populous state, Virginia is also relatively wealthy. Based on the latest estimates by the U.S. Department of Commerce, Virginia had the 12th highest personal income in the country. As Table 2 shows, Virginia's total personal income is well ahead of all the southern states, with the exception of Texas and Florida, which have the third and fourth highest personal income in the U.S., and Georgia which is only slightly ahead of Virginia.

After adjusting personal income for population, Virginia has the 14th highest per capita income in the country and the highest such income of any state in the South except for Maryland, which is fifth. Virginia's per capita income is just below California's and ahead of many other large states.

TABLE 2
Top 20 States in Personal Income and Personal Income Per Capita -- 1999

Personal Income			Personal Income Per Capita		
Rank	**State**	**Amount**	**Rank**	**State**	**Amount**
1	California	$991,381,592,000	1	Connecticut	$39,300
2	New York	$616,677,900,000	2	Massachusetts	$35,551
3	Texas	$538,344,933,000	3	New Jersey	$35,551
4	Florida	$419,792,482,000	4	New York	$33,890
5	Illinois	$377,743,789,000	5	Maryland	$32,465
6	Pennsylvania	$343,088,409,000	6	Colorado	$31,546
7	Ohio	$305,642,627,000	7	Illinois	$31,145
8	New Jersey	$289,503,000,000	8	New Hampshire	$31,114
9	Michigan	$277,295,918,000	9	Nevada	$31,022
10	Massachusett s	$219,533,136,000	10	Minnesota	$30,793
11	Georgia	$212,929,047,000	11	Delaware	$30,778
12	**VIRGINIA**	$204,736,012,000	12	Washington	$30,392
13	North Carolina	$198,943,408,000	13	California	$29,910
14	Washington	$174,948,129,000	**14**	**VIRGINIA**	**$29,789**
15	Maryland	$167,895,034,000	15	Rhode Island	$29,377
16	Indiana	$155,365,345,000	16	Pennsylvania	$28,605
17	Minnesota	$147,050,242,000	17	Alaska	$28,577
18	Missouri	$144,235,170,000	18	Massachusetts	$28,113
19	Wisconsin	$143,811,387,000	19	Florida	$27,780
20	Tennessee	$140,234,146,000	20	Hawaii	$27,544

SOURCE: Bureau of Economic Analysis, U.S. Department of Commerce.

General Fund

To finance the goods and services provided by the Commonwealth in the current 2000-2002 biennium, Virginia will spend approximately $48.7 billion, of which the general fund will finance approximately 51.3 percent. The remaining funds will be generated from non-general fund taxes, fees and charges, and federal reimbursements and payments. The Commonwealth collected $11,111,957,000 from general fund sources in fiscal year 2000, a 10.8 percent increase over the previous year.

Table 3 shows the relative importance of the Virginia individual income tax and the sales and use tax to the general fund. These two sources alone constituted 81.3 percent of the general fund and the five largest sources of tax revenue contributed 89.6 percent of the total general fund. A number of other sources generated large amounts of revenue, but in comparison to the total general fund, yielded a relatively small percentage of the total.

TABLE 3
General Fund Revenue Sources

Source	FY 2000 Collection	% of Total	Cumulative %
Taxes:			
Individual Income	$6,828,907,000	61.5%	61.5%
Sales and Use	$2,201,533,000	19.8	81.3
Corporate Income	$565,909,000	5.1	86.4
Public Service Corporations	$104,197,000	0.9	87.3
Insurance Premiums	$251,074,000	2.3	89.6
Alcoholic Beverage Sales	$117,204,000	1.1	90.7
Estate and Gift	$150,121,000	1.3	92.0
Recordation	$146,288,000	1.3	93.3
Tobacco	$15,208,000	0.1	93.4
Bank Franchise	$12,304,000	0.1	93.5
Other Taxes	($2,509,000)	------	------
Total Taxes	**$10,390,236,000**	**93.5**	**93.5**
Other Revenues			
Net Lottery Profits	$323,475,000	2.9	96.4
Interest	$131,160,000	1.2	97.6
Fines, Forfeitures & Fees	$127,280,000	1.1	98.7
Tobacco Master Settlement	$66,939,000	0.6	99.3
Rights and Privileges	$34,098,000	0.3	99.7
Other Revenue	$38,769,000	0.3	100.0
Total Other Revenue	**$721,721,000**		**100.0**
Total General Fund:	**$11,111,957,000**		

Virginia's growth in population and personal income during the past decade is also reflected in its collections of general fund revenue, which have increased approximately 92.7 percent since 1991 (see Table 4). This time span reflects two very different periods of growth. 1991 and 1992 reflect a Virginia economy during the recession of the early 1990's while the past eight years, ending June 30, 2000, show unprecedented revenue growth. In three of the past four years, Virginia's general fund has experienced double digit revenue growth.

TABLE 4
Virginia General Fund Revenues, Fiscal Years 1991 - 2000

Fiscal Year	Revenues	% Change
1991	$5,766,168,000	+2.0%
1992	5,914,003,000	+2.6%
1993	6,430,723,000	+8.7%
1994	6,806,839,000	+5.8%
1995	7,192,775,000	+5.7%
1996	7,688,683,000	+6.9%
1997	8,466,641,000	+10.1%
1998	9,092,423,000	+7.4%
1999	10,024,622,000	+10.3%
2000	$11,111,957,000	+10.8%

TABLE 5
State Tax Collections Per Capita and as a Percent of State Personal Income, 1999

State	State Tax Collections Per Capita	Rank	1991 Rank	State Tax Collections, as a % of Income	Rank	1991 Rank
Alabama	$1,380.42*	45	44	6.02%	34	32
Alaska	1,461.07*	44	1	5.12%*	46	1
Arizona	1,578.53*	38	19	6.24%	32	11
Arkansas	1,806.45	19	42	8.17%	7	25
California	2,183.96	8	10	7.32%	16	19
Colorado	1,476.07*	43	45	4.66%*	49	48
Connecticut	2,932.21	1	8	7.49%	12	40
Delaware	2,695.01	2	3	8.78%	3	6
Florida	1,574.43*	39	39	5.62%*	43	42
Georgia	1,600.08*	36	35	5.88%	38	33
Hawaii	2,671.17	3	2	9.59%	1	2
Idaho	1,734.54	25	27	7.40%	14	13
Illinois	1,748.90	22	28	5.59%*	44	43
Indiana	1,752.18	21	32	6.72%	21	30
Iowa	1,696.69	29	21	6.60%	23	22
Kansas	1,729.23	26	29	6.49%	26	35
Kentucky	1,857.15	17	13	8.02%	11	5
Louisiana	1,379.19*	46	40	6.05%	33	26
Maine	2,027.53	12	18	8.12%	8	18
Maryland	1,833.07	18	15	5.70%*	42	37
Massachusetts	2,385.65	5	4	6.68%	22	23
Michigan	2,365.66	6	25	8.50%	5	31
Minnesota	2,613.69	4	6	8.54%	4	9
Mississippi	1,652.02*	32	46	8.06%	10	16
Missouri	1,566.03*	40	43	5.98%	35	46
Montana	1,546.60*	41	41	6.93%	20	28
Nebraska	1,597.87*	37	31	5.82%	39	34
Nevada	1,895.81	15	16	6.25%	31	21
New Hampshire	891.49*	50	50	2.88%*	50	50
New Jersey	2,078.54	11	9	5.76%	40	39
New Mexico	2,002.60	13	14	9.08%	2	3
New York	2,126.81	10	7	6.27%	30	24
North Carolina	1,886.90	16	26	7.20%	17	20
North Dakota	1,746.19	23	24	7.42%	13	14
Ohio	1,614.64*	33	36	5.96%	36	38
Oklahoma	1,613.21*	34	22	7.08%	18	12
Oregon	1,610.72*	35	38	5.94%	37	36
Pennsylvania	1,799.96	20	34	6.28%	29	41
Rhode Island	1,912.76	14	20	6.44%	27	29
South Carolina	1,498.68*	42	30	6.38%	28	17

TABLE 5 (CONTINUED)

South Dakota	1,184.25*	49	49	4.72%*	48	49
Tennessee	1,311.44*	47	48	5.13%*	45	47
Texas	1,280.95*	48	47	4.83%*	47	44
Utah	1,711.15	27	37	7.33%	15	15
Vermont	1,703.80	28	23	6.58%	24	27
Virginia	**1,682.36**	**31**	**33**	**5.71%**	**41**	**45**
Washington	2,143.29	9	5	7.07%	19	7
West Virginia	1,742.24	24	17	8.34%	6	4
Wisconsin	2,214.63	7	11	8.08%	9	10
Wyoming	1,694.23	30	12	6.52%	25	8
U.S.	**$1,837.76**			**6.44%**		

* Indicates Rank is Below Virginia
SOURCE: U.S. Department of Commerce
Prepared by the Virginia Division of Legislative Services (7/1/00)

Comparison With Other States

Table 5 provides 1999 data collected by the U.S. Department of Commerce on total state tax collections and adjusts these figures by population and by personal income. It should be noted that rankings generally should be used with extreme caution for a number of reasons. One is a state's mix of state and local taxes. In some states, local governments pay for services that are provided by state governments in other states. Another reason for caution is the state's mix between taxes and the increasing use of user fees and charges. Finally, it is important to keep in mind that, in many cases, taxes are paid in one state, but the burden is shifted to the citizens of another through higher consumer prices. In the state of Alaska, for example, severance taxes equaled almost 47 percent of the total state taxes in 1999, but it is incorrect to assume that residents of Alaska pay such high state taxes, because a large portion of the severance tax is exported.

Table 5 shows that the average Virginia resident paid $1,682.36 in state taxes in 1999, representing general fund and non-general fund sources, well below the U.S. average of $1,837.76. Virginia ranked 31st among the 50 states in this measure.

TABLE 6
State Tax Burden (Selected States) -- 1999
Per Capita and as Percent of Personal Income

State	Per Capita	Rank	% Personal Income	Rank
Kentucky	$1,857.15	17	8.02%	11
Maryland	$1,833.07	18	5.70%	42
North Carolina	$1,886.90	16	7.20%	17
Tennessee	$1,311.44	47	5.13%	45
VIRGINIA	**$1,682.36**	**31**	**5.71%**	**41**
West Virginia	$1,742.24	24	8.34%	6

Tax Burden

Another method used to calculate tax burden is to adjust tax collections by personal income. State taxes in Virginia equaled 5.71 percent of personal income in 1999, which ranked Virginia 41st out of the 50 states. The average state's taxes equaled 6.44 percent of personal income, or 0.73 percent higher than Virginia's. Thus, when ability to pay is factored in, Virginia's tax burden relative to other states is quite low.

In comparison with our neighboring states (Table 6), Virginia's state taxes per capita are relatively low. Kentucky, Maryland, and North Carolina are in the top 20 highest states in state taxes per capita. Only Tennessee is ranked lower at 47th. A comparison of state taxes as a percentage of personal income shows that Virginia has an even more favorable tax ranking. Virginia is ranked 41st, and of our neighboring states, only Maryland (42nd) and Tennessee (45th) have a lower tax burden than Virginia.

Because different levels of government fund different services in other states, Table 7 provides state and local taxes both per capita and as a percentage of personal income. The average Virginian paid $2,524.11 in state and local taxes in 1997. This compares with a U.S. average of $2,747.44. Virginia was ranked 28th. As a percentage of income, state and local taxes equaled 9.90 percent of personal income. This was well below the U.S. average of 11.14 percent. Virginia ranked 46th among the states. Table 8 compares Virginia with our neighboring states. Virginia and its neighboring states rank low relative to all other states in state and local taxes per capita. Virginia's relatively low state and local tax burden is even clearer when adjusted by personal income. Virginia and Tennessee are ranked in the bottom five states in state and local taxes adjusted by personal income.

TABLE 7
State and Local Tax Collections, Per Capita and as a Percentage of Personal Income, 1997

State	State and Local Taxes Per Capita	Rank	State and Local Taxes as a % of Income	Rank
Alabama	$1,854.62	50*	9.12%	48*
Alaska	3,986.11	3	15.30	1
Arizona	2,352.14	35*	10.88	31
Arkansas	2,044.03	46*	10.51	39
California	2,849.85	16	11.14	23
Colorado	2,648.12	21	10.09	44
Connecticut	4,209.17	1	12.56	8

TABLE 7 (CONTINUED)

Delaware	2,965.20	10	11.12	24
Florida	2,470.23	30*	10.03	45
Georgia	2,426.50	33*	10.55	40
Hawaii	3,242.37	7	12.66	7
Idaho	2,292.52	38*	11.24	20
Illinois	2,868.89	14	10.60	35
Indiana	2,526.91	25	11.08	27
Iowa	2,525.57	26	11.12	25
Kansas	2,616.12	22	11.25	19
Kentucky	2,290.93	39*	11.37	16
Louisiana	2,218.90	41*	10.95	30
Maine	2,871.33	13	13.44	3
Maryland	2,933.54	12	10.53	38
Massachusetts	3,307.54	6	11.16	22
Michigan	2,734.39	18	11.17	21
Minnesota	3,384.43	5	12.88	4
Mississippi	1,978.53	49*	10.96	29
Missouri	2,345.95	36*	10.15	43
Montana	2,201.93	42*	11.36	17
Nebraska	2,725.98	19	11.33	18
Nevada	2,854.59	15	10.54	37
New Hampshire	2,372.06	34*	9.10	49*
New Jersey	3,422.00	4	11.10	26
New Mexico	2,485.09	29*	12.77	6
New York	4,159.88	2	14.21	2
North Carolina	2,427.27	32*	10.58	36
North Dakota	2,455.86	31*	11.60	13
Ohio	2,602.10	23	11.00	28
Oklahoma	2,161.99	43*	10.74	32
Oregon	2,524.72	27	10.67	33
Pennsylvania	2,649.14	20	10.66	34
Rhode Island	2,951.36	11	11.74	10
South Carolina	2,087.90	45*	10.22	41
South Dakota	1,985.89	48*	9.21	47*
Tennessee	2,002.28	47*	8.90	50*
Texas	2,288.75	40*	10.16	42
Utah	2,313.25	37*	11.59	14
Vermont	2,760.49	17	12.37	9
Virginia	**2,524.11**	28	9.90	46
Washington	2,966.08	9	11.74	11
West Virginia	2,116.55	44*	11.40	15
Wisconsin	3,019.98	8	12.82	5
Wyoming	2,584.45	24	11.69	12
U.S. AVG.	2,747.44		11.14	

* Indicates Rank is Below Virginia

Source: U.S. Department of Commerce

Prepared by the Virginia Division of Legislative Services (5/22/01)

TABLE 8
State and Local Tax Burden (Selected States)--1997
Per Capita and as a Percent of Personal Income

State	Per Capita	Rank	% Personal Income	Rank
Kentucky	$2,290.93	39	11.37%	16
Maryland	2,933.54	12	10.53%	38
North Carolina	2,427.27	32	10.58%	36
Tennessee	2,002.28	47	8.90%	50
VIRGINIA	**2,524.11**	**28**	**9.90%**	**46**
West Virginia	2,116.55	44	11.40%	15

Summary

Virginia is a large state that has grown rapidly during the past few decades. In terms of population, Virginia is the 12th largest state, and based on personal income it is the 14th largest state in the U.S. In terms of personal income per capita, when Virginia is compared to the other states in the South, only Maryland is ranked higher.

General fund taxes comprised slightly more than one-half of the Commonwealth's $48.7 billion biennial budget. The individual income tax and the sales and use tax comprise three-quarters of total general fund revenue. Virginia has a relatively low state tax burden, especially when compared to our neighboring states. On a per capita basis, Virginia ranked 31st among the 50 states. When state taxes are adjusted by personal income, that is, by ability to pay, Virginia was ranked 41st. In short, despite the periods of growth and recession during the past decade, the Commonwealth's tax burden on its citizens has remained relatively low when compared to other states.

Individual Income Tax

Individual Income Tax

History

Virginia enacted an individual income tax in 1843. The tax and collection practices have since changed; the inclinations of many taxpayers have not. One observer has noted that the individual income tax had "always been 'a tax on the honesty of the citizens' -- or if put more justly and more exactly, a tax on the conception of honesty as existing in the community." Because "it may not be the custom of [the] community to obey the law in this particular at all," for 1912, Middlesex County, along with 14 other counties, claimed no resident admitting an annual income of more than $2,000, which just happened to be the exemption limit. Shenandoah County residents, either more honest or less wily, remitted a total of $30 to the Commonwealth in income taxes for that same year.[1]

Despite the vagaries of individual and community conscience, the individual income tax originated as and remains not only a source for increased government revenue, but an attempt to create a system of taxation whereby those most able to bear the cost of government pay the greatest share for the services provided by government.

From its inception in 1843, the Virginia individual income tax has undergone three major changes, all to expand Virginia's tax base and thereby increase its revenues. Prior to 1843, taxes, in the form of tangible property taxes, fell most heavily on eastern Virginia planters, who also controlled the legislature, and "the income tax appealed to them, in the dire need for more money with which to carry on the continually expanding system of internal improvements, as a tax which would not burden them, but which would cause the nonpropertied wage-earners and salaried individuals, to bear a share of the burden."[2] Hence, before the constitutional convention of 1850-51, the legislature imposed a uniform tax of one percent on the incomes of a growing class of salaried workers and wage-earners whose annual incomes exceeded $400, and a 2.5 percent tax on interest on investments belonging to another growing class, the "capitalists." This powerful new group initiated the first change to the individual income tax: it opposed the tax so successfully that by 1850 the tax was levied only on "salaries."

By 1851, the date of the constitutional convention, reapportionment of the legislature based upon white male suffrage had shifted political and economic control from eastern to western Virginia and from "the plantation owner to the small farmer."[3] As a result of the power shift, the legislature introduced a graduated income tax schedule

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[1] Sydenstricker, Edgar. *A Brief History of Taxation in Virginia.* Richmond: The Legislative Reference Bureau of Virginia, 1915, pp. 52-53.
[2] *Id.*
[3] *Id.*, p. 50.

that exempted "all laborers engaged in mechanic arts, trade, handicraft or manufacture, and ministers of the gospel,"[4] but taxed all other incomes, regardless of their size. For example, incomes below $250 annually were taxed at 0.25 percent and interest from stock at 3.33 percent. Regardless of reforms, however, Virginia income tax revenues for 1855 reached only $19,188.

Between 1860 and 1863, income tax revenues proved insufficient to meet the financial demands of waging war. The legislature abandoned the graduated tax scale, taxed incomes over $500 at 2.5 percent, and taxed interest at 17 percent. The flat rate system of taxation remained in effect after the Civil War and was incorporated into the 1869 Underwood Constitution, which taxed incomes exceeding $600. Until the enactment of the federal income tax provisions in 1913, individual income taxation changed little, with only periodic fluctuations in taxable income levels and taxation percentages. In 1912, Virginia realized only $102,678 in individual income tax revenues, "just enough" for Virginia "to be unwilling to do away with it, and not enough to render it an important enough source of revenue to become an object of serious reform."[5]

The two most significant developments surrounding the income tax since its inception were the movement in 1870 to define income as "all income" (from whatever source derived) and the relative importance the tax now plays in the overall funding for state government.

From these modest beginnings the Virginia individual income tax has grown and will continue to be the single most important source of general fund revenue to the Commonwealth. In fiscal year 2000, the Commonwealth collected $6.8 billion in individual income tax revenue, which comprised 63.3 percent of the Commonwealth's general fund. To place this amount in perspective, the individual and corporate income taxes and the sales and use tax comprise more than 88.9 percent of the total general fund, and the income taxes generate almost three and one-half times the revenue of the sales and use tax.

Until the 1989 Session, the individual income tax had been segregated for state taxation only. However, the 1989 Session allowed the Northern Virginia localities, as well as the City of Norfolk, to impose a local income tax of up to one percent for transportation purposes, if such local tax was approved at a referendum. The tax would expire five years after its enactment.[6] At this time, no locality has placed this tax on the ballot.

The Commonwealth's individual income tax revenues have grown more rapidly during the past decade than any other tax, because the income tax captures the income resulting from real economic growth, population growth, and inflation, all at progressive tax rates. In fiscal year 1984, the individual income tax comprised only 51.5 percent of the general fund; 16 years later, it comprised 63.3 percent (See Table 1).

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[4] *Id.*
[5] *Id.*, p. 53.
[6] Chapter 245, *Acts of Assembly*, 1989.

TABLE 1
Individual Income Tax Revenues
Fiscal Years 1991 - 2000

Fiscal Year Ending June 30	Tax	% Increase Over Previous Year
1991	$3,236,011,000	5.0
1992	$3,321,243,000	2.6
1993	$3,584,765,000	7.9
1994	$3,811,860,000	6.3
1995	$4,028,114,000	5.7
1996	$4,348,039,000	7.9
1997	$4,727,791,000	8.7
1998	$5,405,440,000	14.3
1999	$6,087,851,000	12.6
2000	$6,828,907,000	12.2

As a result of legislation enacted by the 1971 Session of the General Assembly, Virginia conformed its income tax law, in large part, to the federal individual income tax structure.[7] Conformity was adopted on the recommendations of the Virginia Income Tax Study Commission to the 1968 Session and the Income Tax Conformity Statute Study Commission to the 1971 Session. Both commissions reasoned that conformity would benefit the taxpayer as well as the Commonwealth by establishing a state income tax structure similar to the federal income tax, thereby reducing the administrative and compliance burden of the tax. Previously, Virginia had its own definition of income, its own standard deduction and exemption amounts, and its own rules and regulations to interpret its statutes, as well as its own audit function.

Individual Income Tax Structure

Conformity

Federal adjusted gross income (AGI) is the starting point in the determination of Virginia taxable income. Federal AGI includes wages and salaries, dividends, interest, unemployment compensation, capital gains and losses, rental income, and such adjustments as IRA contributions, alimony, interest on educational loans, and depreciation. The major benefit of conformity is simply that Virginia, by conforming to federal AGI, allows the taxpayer to use the same starting point in the computation of both state and federal income taxes. The Commonwealth benefits in the administration of the tax, including compliance efforts, by relying on the federal government for computer tapes of federal returns to verify certain information. Both the Commonwealth and the taxpayer have the benefit of reliance on the rules and regulations promulgated by the Internal Revenue Service. The key is to have the same starting point.

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[7] Chapter 171, *Acts of Assembly*, 1971.

While the starting point in computing Virginia income taxes is federal AGI, the actual amount of income tax owed to Virginia is calculated in a manner that deviates from the computation of federal income tax liability. Virginia allows certain subtractions from federal AGI, which reduce the amount of individual income subject to Virginia income tax. Virginia allows a subtraction from federal AGI for any unemployment compensation received; however, unemployment compensation is taxable income for federal income tax purposes. Other Virginia subtractions include a subtraction up to the first $15,000 of military basic pay and subtractions for the first $15,000 of salary of state and federal employees whose salary is $15,000 or less.

As more modifications to federal AGI are passed by the General Assembly, some of the benefits of using federal AGI as a starting point are gradually lost. The administration of the individual income tax becomes more complex as modifications to federal AGI are made, and compliance and auditing efforts become more complicated because federal AGI no longer serves as a barometer of the income subject to Virginia individual income taxes. Federal AGI is merely the starting point in determining the base income amount subject to tax.

Exemptions

The Virginia individual income tax currently provides an exemption of $800 for each personal, dependent, age, or blind exemption. The 1999 federal personal exemption amount is $2,750 for each personal and dependent exemption (indexed starting in taxable year 1990). Moreover, the federal income tax no longer provides an additional personal exemption for taxpayers who are age 65 or over or blind, allowing instead an increased standard deduction of $850 for each category, $1,050 for each category for unmarried taxpayers, and no additional deduction for taxpayers who itemize.

Standard and Itemized Deductions

A federal taxpayer may claim either a standard deduction or itemized deductions. Virginia conforms its itemized deductions with the major exception of the federal deduction for state income taxes. If the taxpayer claims itemized deductions on the federal return, he must also itemize on the Virginia income tax return, even if such amount is less than the standard deduction. Since taxable year 1989, the standard deduction in Virginia has been $3,000 for single taxpayers and $5,000 for a married couple. At the federal level, the 1999 standard deduction is $4,300 for a single person and $7,200 for a married couple. For 1989 and after, these amounts are indexed to the annual increase in the consumer price index.

Subtractions, Other Deductions, and Tax Credits

During the past 10 years, Virginia's individual income tax structure has undergone a major change. In the early 1990s the foundation of Virginia's income tax structure included three major components: federal AGI, standard or itemized deductions, and personal exemptions. By taxable year 1999, new subtractions from federal AGI, deductions (other than the standard or itemized deductions), and tax credits assumed a major role in determining individual income tax liability. All three operate to reduce income tax paid to the Commonwealth.

Since 1994, there have been at least 27 new subtractions, deductions, and tax credits enacted into law. By comparison, in 1971 when Virginia conformed, Virginia provided only a very limited credit for taxes paid to other states. During the 1970s, the General Assembly adopted only one new credit -- the retirement income tax credit for taxpayers age 62 or over, which was enacted by the 1976 Session of the General Assembly.

Some of the new subtractions, deductions, and tax credits include a subtraction for unemployment compensation, a subtraction up to the first $15,000 of military basic pay, subtractions for the first $15,000 of salary of certain state and federal employees, a subtraction for gains on land held for conservation uses, a deduction for teacher continuing education costs, a deduction for long-term health care insurance, a deduction for amounts contributed to a prepaid tuition contract, a tax credit for low-income taxpayers, a tax credit for hiring recipients of Temporary Assistance to Needed Families (TANF) funds, a tax credit for rehabilitating historic structures, and a tax credit for the cost of adopting agricultural best management practices. A number of factors appear to account for the increase in the number of new subtractions, deductions, and tax credits. The federal government has increased the number of subtractions, deductions, and tax credits under the federal income tax. As an example, Congress adopted a subtraction from federal income for interest paid on certain educational loans, beginning with taxable year 1998.

In addition, the new subtractions, deductions, and tax credits have come at a time of tremendous growth in general fund revenues. Table 2 highlights the growth in general fund revenues during the mid and late 1990s, with much of the growth attributable to increases in individual income tax revenues. Subtractions, deductions, and tax credits are one means of returning surplus revenues back to Virginia citizens.

TABLE 2
Growth in General Fund Revenues
Fiscal Years 1995 - 2000

Fiscal Year Ending June 30	% Increase Over Previous Year
1995	5.8
1996	6.9
1997	10.4
1998	10.4
1999	10.6
2000	11.2

Minimum Filing Level

In order to reduce the burden of the income tax on lower income individuals and to eliminate some returns where the cost of processing is greater than the tax revenue, Virginia established a minimum filing level. For a single person, no individual income tax is required if Virginia AGI is $5,000 or less. For a married couple, no return is required if Virginia AGI is $8,000 or less. Virginia AGI is defined as federal AGI with certain modifications unique to Virginia.

Filing by Married Taxpayers

Under Virginia law, if a husband and wife file a joint federal income tax return, they may elect to file separate Virginia income tax returns on a combined form. This method of filing represents a tax reduction for most married persons where both have income. By separating the incomes and deductions on a combined return, a lower income tax rate is applied to the first $17,000 of each spouse's income.

Tax Rate

The present individual income tax rate schedule became effective for all taxable years beginning with 1972 and has remained unchanged except that the top income tax rate bracket was modified by the Virginia Tax Reform Act of 1987. This modification made the top rate bracket of 5.75 percent applicable to taxable income greater than $17,000. Prior to this change, all income over $12,000 was taxed at 5.75 percent. The tax rate schedule for taxable years 1990 and after is as follows:

Net Taxable Income	Rate
First $3,000	2%
$3,001 - $5,000	3%
$5,001 - $17,000	5%
Greater than $17,000	5.75%

Virginia's income tax rate schedule prior to conformity was identical to that adopted effective taxable year 1972, except that the 1972 Session added the 5.75 percent bracket.[8]

Tax Computation

Step One

Federal AGI is determined from the federal individual income tax return. From that amount, there are certain additions to federal AGI, such as interest on obligations from other states, and certain subtractions from federal AGI. The subtractions include:

- The portion of social security taxed for federal income tax purposes;
- Up to $20,000 of disability income for a permanent and total disability;
- Lottery prizes less than $600;
- A portion of National Guard wages and salaries (maximum subtraction is $3,000);
- Crime Solver rewards up to $1,000;
- Qualified agricultural contributions (gleaning);
- Qualified research expenses not deducted on a federal income tax return;
- Refunds from a prepaid tuition contract or savings trust account with the Virginia College Savings Plan;
- Gains on the sale of real property, which is held for open-space use as a result of the sale;
- Up to the first $15,000 of military basic pay for military service personnel on active duty;
- The first $15,000 of salary of federal and state employees whose annual salary is $15,000 or less;
- Unemployment compensation income;
- Certain reparation payments to Holocaust victims; and
- Income received as a result of the Master Settlement Agreement reached between tobacco companies and the states, the National Tobacco Grower Settlement Trust dated July 19, 1999, and the Tobacco Loan Assistance Program.

The result of these additions and subtractions to federal adjusted gross income equals Virginia adjusted gross income (AGI). If Virginia AGI is $5,000 or less for a single taxpayer or $8,000 or less for a married couple, no tax return need be filed.

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[8] Chapter 563, *Acts of Assembly*, 1972.

Step Two

Step Two involves deducting from Virginia AGI the personal exemption amount, which is $800 per taxpayer and dependent, and an additional $800 for each taxpayer age 65 or over and each taxpayer who is blind, and either the standard deduction amount or the itemized deduction amount. The itemized deduction allowable under Virginia income tax law equals the federal itemized deduction minus the itemized deduction for income tax paid to another state or locality. These deductions from Virginia AGI yield Virginia taxable income, and the Virginia tax rate schedule is then applied to determine the Virginia individual income tax. There are also several other deductions, including:

- An amount for child care expended by the taxpayer based on the federal child care credit allowance;
- A $1,000 deduction for each child residing in a home under permanent foster care placement;
- $12,000 for taxpayers age 65 or older, or $6,000 for taxpayers age 62-64;
- An amount paid or contributed to a prepaid tuition contract or savings trust account up to $2,000 per contract or savings trust account, provided that such payment or contribution is not deducted on a federal income tax return (the $2,000 limit does not apply to persons age 70 or older);
- An amount contributed to the Virginia Public Schools Construction Grants Program and Fund provided that such amount is not deducted on a federal income tax return;
- An amount equal to 20 percent of tuition costs paid by teachers for continuing education; and
- An amount paid in premiums for long-term health care insurance.

Step Three

Before calculating the final tax liability, Virginia grants a number of tax credits that reduce the Virginia individual income tax. The resulting net tax liability is the amount of income tax due to the Commonwealth. Exhibit A at the end of this section enumerates the tax credits made available to Virginia individuals. These tax credits include, but are not limited to:

- Neighborhood Assistance Act tax credit;
- Conservation Tillage Equipment tax credit;
- Low-Income Housing tax credit;
- Purchase of advanced technology pesticide and fertilizer application equipment tax credit;
- Purchase of machinery and equipment for processing recyclable materials;
- Rent Reduction tax credit;

- Historic Rehabilitation tax credit;
- Day-Care Facility Investment tax credit; and
- Agricultural Best Management Practices tax credit.

In contrast to the deductions described in Step Two, tax credits offer a greater financial incentive than a flat deduction. For example, the credit for the purchase of conservative tillage equipment provides a credit of 25 percent of all expenditures for the purchase and installation of conservation tillage equipment used in agricultural production. In the case of a $10,000 piece of equipment, the Virginia credit would equal $2,500 (25 percent x $10,000), compared to a maximum savings of $575 (5.75 percent x $10,000) under a deduction, assuming the taxpayer was at the top tax rate. This is because a deduction reduces Virginia AGI, which is subject to a maximum tax rate of 5.75 percent, while a tax credit reduces the amount of income tax due on a dollar for dollar basis. This example highlights different levels of incentives and the major difference between a credit and a deduction. A credit can be constructed to provide the desired incentive, while the value of a deduction depends on the taxpayer's situation.

Comparison with Other States

As of July 1, 2000, 40 states plus the District of Columbia imposed a broad-based income tax on individuals. Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming impose no income tax and Tennessee and New Hampshire limit their income tax to interest and dividends. Most states have conformed their income taxes to the federal tax laws during the 1960s and 1970s. For example, in 1958, only four states conformed generally to the federal income tax; by 1976, 19 of the 35 states with broad-based income taxes conformed. The trend continues today, with some states conforming to the point of computing their state taxes as a percentage of federal liability. Currently, 35 of the 40 states conform their income tax, in general, to the federal tax laws.

Most states, however, do not exercise complete conformity. Many states provide modifications to the federal provisions due to specific state considerations. A major drawback to conformity occurs if a state conforms to the federal definition of "adjusted gross income" (AGI), personal exemption amounts, and standard deduction amounts. The state then becomes dependent on federal law and forfeits much of its independence. Changes in the federal income tax law would directly affect, either positively or negatively, state revenue collections, absent definitive state intervention.

Table 3 compares the personal exemption amounts permitted by the states under their income tax structures. In terms of the personal exemption amount, Wisconsin has the lowest personal exemption ($600) of any state imposing a broad-based individual income tax. Virginia is next with a $800 personal exemption. Indiana, New Jersey, and Oklahoma grant the next lowest personal exemption, $1,000. The table also shows that seven states provide a credit against the tax in lieu of a personal exemption. The federal income tax allows a personal exemption of $2,750 for 1999.

Table 4 compares the standard deduction permitted by the states. In 1989, Virginia compared favorably by providing what was considered a very generous standard deduction of $3,000 for each single taxpayer and $5,000 for each married couple. Twelve other states also provided a standard deduction of $3,000 for each single taxpayer and $5,000 for each married couple. In each of these 12 states, however, the state standard deduction is linked (indexed) to the federal deduction, and as the federal standard deduction has increased to $4,300 for single persons and $7,200 for married persons for tax year 1999, due to indexing, these states' standard deductions also increased automatically. Virginia is not tied to the federal standard deduction amount and therefore only adjusts periodically as conditions warrant. As a result, of the 31 states that granted a standard deduction for tax year 1999, 17 granted a standard deduction for single and married persons that was higher than the standard deduction granted by Virginia. Iowa has the lowest standard deduction for single persons ($1,460), and Kentucky has the lowest standard deduction for married persons ($1,500).

Table 5 compares the Virginia individual income tax rate schedule to those in other states. As the table demonstrates, the states vary greatly in their tax rate structure, with Colorado, Illinois, Indiana, Michigan, Pennsylvania, Rhode Island, and Vermont, which impose one flat tax rate regardless of taxable income, at one end of the spectrum, and Missouri and Montana with 10 different tax rate brackets at the other end. This table reveals that Virginia's top marginal income tax rate is relatively low compared to the other states. Of the 40 states with broad-based income taxes, 28 have a higher top tax rate, with only 10 lower.

Generally, there are two ways to compare the burden or utilization of taxes among the states. The first method is to divide tax collections by populations to determine average tax collection per resident (per capita). The other method is to calculate the tax burden by stating the tax as a percentage of personal income, thus eliminating the distortion caused by differing per capita income levels among states. An average tax of $1,000, for example, represents a much heavier burden in a state with average per capita income of $12,000 than in a state with average income of $20,000. Table 6 shows per capita income tax and income taxes as a percentage of personal income for Virginia and selected other states.

TABLE 3
State Individual Income Taxes, Personal Exemptions, 1999

State	Single	Married	State	Single	Married
Alabama	$1,500	$3,000	Montana	$1,610	$1,610
Alaska	No State	Income Tax	Nebraska	89c	188c
Arizona	$2,100	$4,200	Nevada	No State	Income Tax
Arkansas	20c	40c	New Hampshire	$2,400	$4,800
California	72c	144c	New Jersey	$1,000	$2,000
Colorado	$2,750	$5,500	New Mexico	$2,750	$5,500
Connecticut*	$12,000	$24,000	New York	0	0
Delaware	100c	200c	North Carolina	$2,500	$5,000
Florida	No State	Income Tax	North Dakota	$2,750	$5,500
Georgia	$2,700	$5,400	Ohio	$1,050	$2,100
Hawaii	$1,040	$2,080	Oklahoma	$1,000	$2,000
Idaho	$2,750	$5,500	Oregon	134c	268c
Illinois	$1,300	$2,600	Pennsylvania	0	0
Indiana	$1,000	$2,000	Rhode Island	$2,750	$5,500
Iowa	40c	80c	South Carolina	$2,750	$5,500
Kansas	$2,250	$4,500	South Dakota	No State	Income Tax
Kentucky	20c	40c	Tennessee	Limited State	Income Tax
Louisiana*	$4,500	$9,000	Texas	No State	Income Tax
Maine	$2,750	$5,500	Utah	75% Federal	Exemption
Maryland	$1,850	$3,700	Vermont	$2,750	$5,500
Massachusetts	$4,400	$8,800	Virginia	$800	$1,600
Michigan	$2,800	$5,600	Washington	No State	Income Tax
Minnesota	$2,750	$5,500	West Virginia	$2,000	$4,000
Mississippi	$6,000	$11,000	Wisconsin	600	1,200
Missouri	$2,100	$4,200	Wyoming	No State	Income Tax
Federal	**$2,750**	**$5,500**			

*Personal exemption and standard deduction amounts are combined.

c denotes credit

SOURCE: *All States Tax Handbook*, 2000, published by RIA.

TABLE 4
State Individual Income Taxes, Standard Deductions 1999

State	Percent Limit of AGI	Single	Married, Joint Return
Alabama	20.0	$2,000	$4,000
Alaska	No	State Income	Tax
Arizona	0.0	$3,600	$7,200
Arkansas	10.0	$2,000	$4,000
California	-----	$2,711	$5,422
Colorado	-----	$4,300	$7,200
Connecticut	Standard	Deduction	Not Available
Delaware	10.0	$3,250	$4,000
Florida	No	State Income	Tax
Georgia	-----	$2,300	$3,000
Hawaii	-----	$1,500	$1,900
Idaho	-----	$4,300	$7,350
Illinois	Standard	Deduction	Not Available
Indiana	Standard	Deduction	Not Available
Iowa	-----	$1,460	$3,590
Kansas	-----	$3,000	$5,400
Kentucky	-----	$1,500	$1,500
Louisiana	Standard	Deduction	Not Available
Maine	-----	$4,300	$7,200
Maryland	15.0	$2,000	$4,000
Massachusetts	Standard	Deduction	Not Available
Michigan	Standard	Deduction	Not Available
Minnesota	-----	$4,300	$7,200
Mississippi	-----	$2,300	$4,600
Missouri	-----	$4,300	$7,200
Montana	20.0	$3,020	$6,040
Nebraska	-----	$4,300	$7,200
Nevada	No	State Income	Tax
New Hampshire	Very Limited	State Income	Tax
New Jersey	Standard	Deduction	Not Available
New Mexico	-----	$4,300	$7,200
New York	-----	$7,500	$13,000
North Carolina	-----	$3,000	$5,000
North Dakota	-----	$4,300	$7,200
Ohio	Standard	Deduction	Not Available
Oklahoma	15.0	$2,000	$2,000
Oregon	13.0	$1,800	$3,000
Pennsylvania	Standard	Deduction	Not Available
Rhode Island	-----	$4,300	$7,200
South Carolina	-----	$4,300	$7,200
South Dakota	No	State Income	Tax
Tennessee	Very Limited	State Income	Tax
Texas	No	State Income	Tax
Utah	-----	$4,300	$7,200
Vermont	-----	$4,300	$7,200
Virginia	-----	$3,000	$5,000

TABLE 4 (continued)

Washington	No	State Income	Tax
West Virginia	Standard	Deduction	Not Available
Wisconsin	-----	$5,200	$8,900
Wyoming	No	State Income	Tax
FEDERAL	**-----**	**$4,300**	**$7,200**

c denotes credit.

SOURCE: *All States Tax Handbook*, 2000, published by RIA.

TABLE 5
1999 State Individual Income Tax Rates

State	Taxable Income	Rate	State	Taxable Income	Rate
Alabama (1)	$1 - $500	2.0%	Arizona (1)	$1 - $10,000	2.87%
	$501 - $3,000	4.0%		$10,001 - $25,000	3.27%
	$3,001 - and over	5.0%		$25,001 - $50,000	3.74%
				$50,001 - $150,000	4.72%
				$150,001 - and over	5.04%
Arkansas	$1 - $3,099	1.0%	California	$1 - $10,528	1.0%
	$3,100 - $6,099	2.5%	(2)	$10,529 - $24,954	2.0%
	$6,100 - $9,199	3.5%		$24,955 - $39,384	4.0%
	$9,200 - $15,299	4.5%		$39,385 - $54,674	6.0%
	$15,300 - $25,399	6.0%		$54,675 - $69,096	8.0%
	$25,400 - and over	7.0%		$69,096 - and over	9.3%
Colorado	ALL	4.75%	Connecticut	$1 - $10,000	3.0%
			(1)	$10,001 - and over	4.5%
Delaware	$1 - $2,000	0.0%	District of	$1 - $10,000	6.0%
	$2,001 - $5,000	2.6%	Columbia	$10,001 - $20,000	8.0%
	$5,001 - $10,000	4.3%		$20,001 - and over	9.5%
	$10,001 - $20,000	5.2%			
	$20,001 - $25,000	5.6%			
	$25,001 - $60,000	5.95%			
	$60,001 - and over	6.4%			
Georgia	$1 - $750	1.0%	Hawaii (2)	$1 - $ 4,000	1.6%
	$751 - $2,250	2.0%		$4,001 - $8,000	3.9%
	$2,251 - $3,750	3.0%		$8,001 - $16,000	6.8%
	$3,751 - $5,250	4.0%		$16,001 - $24,000	7.2%
	$5,251 - $7,000	5.0%		$24,001 - $32,000	7.5%
	$7,001 - and over	6.0%		$32,001 - $40,000	7.8%
				$40,001 - $60,000	8.2%
				$60,001 - $80,000	8.5%
				$80,001 - and over	8.75%

TABLE 5 (continued)

Idaho	$1 - $1,000	2.0%	Illinois	ALL	3.0%
	$1,001 - $2,000	4.0%			
	$2,001 - $3,000	4.5%			
	$3,001 - $4,000	5.5%			
	$4,001 - $5,000	6.5%			
	$5,001 - $7,500	7.5%			
	$7,501 - $20,000	7.8%			
	$20,001 - and over	8.2%			
Indiana	ALL	3.4%	Iowa	$1 - $1,148	.36%
				$1,149 - $2,296	.72%
				$2,297 - $4,592	2.43%
				$4,593 - $10,332	4.50%
				$10,333 - $17,222	6.12%
				$17,223 - $22,962	6.48%
				$22,963 - $34,442	6.80%
				$34,443 - $51,660	7.92%
				$51,661 - and over	8.98%
Kansas (2)	$1 - $30,000	3.5%	Kentucky	$1 - $3,000	2.00%
	$30,001 - $60,000	6.25%		$3,001 - $4,000	3.00%
	$60,001 and over	6.45%		$4,001 - $5,000	4.00%
				$5,001 - $8,000	5.00%
				$8,001 and over	6.00%
Louisiana	$1 - $10,000	2.0%	Maine	$1 - $2,750	2.0%
	$10,001 - $50,000	4.0%		$2,751 - $6,850	4.5%
	$50,001 and over	6.0%		$6,851 - $15,100	7.0%
				$16,501 - and over	8.5%
Maryland	$1 - $1,000	2.0%	Mass.	Interest and dividends	5.95%
	$1,001 - $2,000	3.0%		Short-term capital gains	12.00%
	$2,001 - $3,000	4.0%		All Other Taxable Income	5.95%
	$3,001 - and over	4.85%			
Michigan	ALL	4.4%	Minnesota	$1 - $25,220	5.5%
				$25,221 - $100,200	7.25%
				$100,201 - and over	8.0%
Mississippi	$1 - $5,000	3.0%	Missouri	$1 - $1,000	1.5%
	$5,001 - $10,000	4.0%		$1,001 - $2,000	2.0%
	$10,001 and over	5.0%		$2,001 - $3,000	2.5%
				$3,001 - $4,000	3.0%
				$4,001 - $5,000	3.5%
				$5,001 - $6,000	4.0%
				$6,001 - $7,000	4.5%
				$7,001 - $8,000	5.0%
				$8,001 - $9,000	5.5%
				$9,001 and over	6.0%

TABLE 5 (continued)

Montana	$1 - $2,000	2.0%	Nebraska	$1 - $2,400	2.51%
	$2,001 - $4,000	3.0% (less $20 tax)		$2,401 - $17,000	3.49%
	$4,001 - $8,000	4.0% (less $60 tax)		$17,001 - $26,500	5.01%
	$8,001 - $12,100	5.0% (less $140 tax)		$26,501 - and over	6.68%
	$12,101 - $16,100	6.0% (less $261 tax)			
	$16,101 - $20,100	7.0% (less $422 tax)			
	$20,101 - $28,200	8.0% (less $623 tax)			
	$28,201 - $40,200	9.0% (less $905 tax)			
	$40,201 - $70,400	10.0% (less $1,307 tax)			
	$70,401 - and over	11.0% (less $2,011 tax)			
New Jersey	$1 - $20,000	1.4%	New Mexico	$1 - $5,500	1.7%
	$20,001 - $50,000	1.75%		$5,501 - $11,000	3.2%
	$50,001 - $70,000	2.45%		$11,001 - $16,000	4.7%
	$70,001 - $80,000	3.5%		$16,001 - $26,000	6.0%
	$80,001 - $150,000	5.525%		$26,001 - $42,000	7.1%
	$150,001 and over	6.37%		$42,001 - $65,000	7.9%
				$65,001 - and over	8.2%
New York (1)	$1 - $8,000	4.0%	North Carolina	$1 - $12,750	6.0%
	$8,001 - $11,000	4.5%		$12,751 - $60,000	7.0%
	$11,001 - $13,000	5.25%		$60,001 - and over	7.75%
	$13,001 - $20,000	5.9%			
	$20,001 - and over	6.85%			
North Dakota	$1 - $3,000	2.67%	Ohio	$1 - $5,000	0.743%
	$3,001 - $5,000	4.00%		$5,001 - $10,000	1.486%
	$5,001 - $8,000	5.33%		$10,001 - $15,000	2.972%
	$8,001 - $15,000	6.67%		$15,001 - $20,000	3.715%
	$15,001 - $25,000	8.00%		$20,001 - $40,000	4.457%
	$25,001 - $35,000	9.33%		$40,001 - $80,000	5.201%
	$35,001 - $50,000	10.67%		$80,001 - $100,000	5.943%
	$50,001 and over	12.00%		$100,001 - $200,000	6.9%
				$200,001 and over	7.5%
Oklahoma	$1 - $1,000	0.5%	Oregon (1)	$1 - $2,350	5.0%
	$1,001 - $2,500	1.0%		$2,351 - $5,850	7.0%
	$2,501- $ 3,750	2.0%		$5,851 - and over	9.0%
	$3,751 - $4,900	3.0%			
	$4,901 - $6,200	4.0%			

TABLE 5 (continued)

	$6,201 - $7,700	5.0%			
	$7,701 - $10,000	6.0%			
	$10,001 and over	6.75%			
Pennsylvania	ALL	2.8%	Rhode Isl.	26.5% of Federal	Inc. Tax
South Carolina	$1 - $2,340	2.5%	Utah (1)	$1 - $750	2.3%
	$2,341 - $4,680	3.0% (less $11 tax)		$751 - $1,500	3.3%
				$1,501 - $2,250	4.2%
	$4,681 - $7,020	4.0% (less $58 tax)		$2,251 - $3,000	5.2%
				$3,001 - $3,750	6.0%
	$7,021 - $9,360	5.0% (less $128 tax)		$3,751 and over	7.0%
	$9,361 - $11,700	6.0% (less $222 tax)			
	$11,701 - and over	7.0% (less $339 tax)			
Vermont	25% of Federal	Inc. Tax	Virginia	$1 - $3,000	2.00%
				$3,001 - $5,000	3.00%
				$5,001 - $17,000	5.00%
				$17,001 and over	5.75%
West Virginia	$1 - $10,000	3.0%	Wisconsin	$1 - $10,160	4.77%
	$10,001 - $25,000	4.0%		$10,161 - $20,320	6.37%
	$25,001 - $40,000	4.5%		$20,321 - and over	6.77%
	$40,001 - $60,000	6.0%			
	$60,001 - and over	6.5%			

SOURCE: *All States Tax Handbook*, Prentice-Hall, Inc.

(1) Rates are the same for married persons filing jointly except income brackets are doubled.

(2) Single persons use same rates but on one-half of applicable income brackets.

TABLE 6
Income Tax Per Capita and as a Percent of Income, Selected States

State	Income Tax Per Capita	Rank (Total = 50)	Tax as a Percent of Personal Income	Rank (Total = 50)
Alabama	$412.12	37	2.01%	35
Georgia	$695.79	16	2.71%	18
Indiana	$689.09	19	3.14%	13
Kentucky	$614.29	27	3.51%	9
Maryland	$806.10	11	3.98%	3
North Carolina	$811.60	10	3.25%	11
Ohio	$621.60	24	3.52%	8
South Carolina	$544.18	32	2.60%	20
VIRGINIA	**$795.93**	**12**	**2.71%**	**19**
West Virginia	$478.21	35	2.32%	32
U.S. Average	$597.72		2.41%	

SOURCE: *State Rankings 2000,* Kathleen O'Leary Morgan and Scott Morgan, Morgan Quitno Press, 11th edition*; State Fact Finder 2000*, Hovey & Hovey, CQ Press.

On a per capita basis, Virginia collected $795.93 of individual income tax per person, the 12th highest collection in the country. Virginia's income tax in aggregate is 2.71 percent of personal income, which ranks Virginia 19th in the country. When collections are adjusted on a personal income basis, Virginia ranks behind Maryland (third), Kentucky (ninth), North Carolina (11th), and equal with Georgia. Virginia ranks ahead of South Carolina (20th) and West Virginia (32nd).

It is also important to examine how heavily different states rely on the individual income tax to generate state tax revenue. In 1998, states received, on the average, 33.9 percent of their total state tax revenue from the individual income tax. Virginia received 51.3 percent of its total state revenues from individual income tax. Only two states (Oregon and Massachusetts) rely more on the individual income tax. The top 10 states are as follows:

1.	Oregon	68.8%
2.	Massachusetts	55.4%
3.	**Virginia**	**51.3%**
4.	New York	50.6%
5.	Colorado	48.9%
6.	Georgia	45.9%
7.	Wisconsin	45.3%
8.	Maryland	45.0%
9.	North Carolina	44.2%
10.	Indiana	41.7%
	U.S. Average	33.9%

SOURCE: U.S. Bureau of the Census, 1998

Since 1993, the last time this guide was published, at least 34 states have reduced their individual income tax rates or increased their personal exemptions and standard deductions. Virginia last changed its income tax rates, personal exemptions, and standard deductions in 1987.

Virginia has granted tax relief to individuals through other means than making changes to its income tax. During the past few years, the General Assembly has passed legislation phasing in a reduction of the tangible personal property tax on personal-use automobiles (1998), repealing the sales and use tax on nonprescription drugs (1998), and phasing out the state sales tax on food purchased for human consumption (1999). Many states, in the alternative, have granted individual tax relief by reducing individual income taxes.

Individual Income Tax Base

For the latest available year (taxable year 1997), Virginians incurred a Virginia individual income tax liability of $4.744 billion, which can be broken down by the distribution of Virginia adjusted gross income (VAGI) and the individual income tax liability by different adjusted gross income categories.

Table 7 provides a distribution of VAGI, Virginia taxable income, and Virginia individual income tax liability and illustrates the distribution of income and tax liability. An examination of each level of VAGI, its percentage of total income, and its comparison to that level's percentage of individual income tax highlights the progressive nature of Virginia's income tax. For example, taxpayers at the $20,000 - $24,999 income level comprise four percent of total VAGI, while paying three percent of the total Virginia individual income tax. This contrasts sharply to the highest VAGI level, where taxpayers had 35.1 percent of the total VAGI, and paid 42.4 percent of the total individual income tax.

Table 8 provides information regarding the distribution of Virginia individual income tax returns, personal and dependent exemptions, and the age exemption. Clearly, the number of returns is skewed toward the lower income levels. For example, 24.7 percent of all the returns came from VAGI levels of less than $10,000, and 42.7 percent of returns came from VAGI levels of less than $20,000. This group also claimed 64.4 percent of the age exemptions, but only 33.0 percent of personal and dependent exemptions. In contrast, taxpayers in the VAGI range of $40,000 - $74,999 filed 20.4 percent of the returns and claimed 25.5 percent of the personal and dependent exemptions, but only 11.2 percent of the age exemptions.

Table 9 examines by VAGI level the distribution of itemized deductions compared to standard deductions. The table clearly shows that taxpayers with higher VAGI levels itemize their deductions. The rough break-even point (51.8 percent itemized, 48.2 percent standard) is at the VAGI level of $25,000 - $29,999. The majority of taxpayers at each VAGI category above this level itemize deductions (99.4 percent at the highest level); the majority of taxpayers below this level claim the standard deduction (91.5 percent at the lowest level).

TABLE 7
Distribution of Virginia Adjusted Gross Income, Virginia Taxable Income and Virginia Individual Income Tax, Taxable Year 1997

Range	Virginia Adjusted Gross Income		Virginia Taxable Income		Virginia Individual Income Tax	
	Amount	% of Total	Amount	% of Total	Amount	% of Total
$0 - $4,999	$ 796,004,285	0.7	$ 37,778,786	0.0	$ 775,931	0.0
$5,000 - $9,999	$ 2,200,421,662	1.9	$ 913,789,966	1.0	$ 21,837,920	0.5
$10,000 - $14,999	$ 3,371,517,220	2.8	$ 2,012,081,883	2.1	$ 67,194,276	1.4
$15,000 - $19,999	$ 4,243,045,586	3.6	$ 2,884,223,158	3.0	$111,924,522	2.4
$20,000 - $24,999	$ 4,746,485,721	4.0	$ 3,445,209,693	3.6	$144,125,743	3.0
$25,000 - $29,999	$ 4,953,857,534	4.2	$ 3,720,860,436	3.9	$164,706,386	3.5
$30,000 - $34,999	$ 5,035,970,448	4.2	$ 3,853,442,689	4.1	$176,350,884	3.7
$35,000 - $39,999	$ 5,067,376,184	4.3	$ 3,922,399,072	4.1	$183,071,778	3.9
$40,000 - $44,999	$ 5,030,622,156	4.2	$ 3,929,999,916	4.2	$186,141,234	3.9
$45,000 - $49,999	$ 4,970,833,333	4.2	$ 3,916,528,203	4.1	$187,930,402	4.0
$50,000 - $74,999	$22,014,773,397	18.6	$17,643,307,917	18.6	$872,970,384	18.4
$75,000 - $99,999	$14,581,029,454	12.3	$11,907,687,290	12.6	$613,700,127	12.9
$100,000 and over	$41,612,641,810	35.1	$36,497,225,404	38.5	$2,012,788,766	42.4
Total	$118,624,641,810	100	$94,684,534,413	100	$4,743,518,353	100

TABLE 8
Distribution of Virginia Individual Income Tax Returns, Personal and Dependent Exemptions, and Virginia Age Exemptions, Taxable Year 1997

Virginia AGI	# of Returns	% of Total	Personal & Dependent Exemptions	% of Total	Age Exemption	% of Total
$0 - $4,999	408,983	14.3	567,367	9.8	169,175	39.8
$5,000 - $9,999	296,108	10.4	450,677	7.8	42,710	10.1
$10,000 - $14,999	270,489	9.5	461,224	7.9	34,057	8.0
$15,000 - $19,999	243,284	8.5	435,817	7.5	27,491	6.5
$20,000 - $24,999	211,657	7.4	392,745	6.8	21,656	5.1
$25,000 - $29,999	180,559	6.3	344,263	5.9	17,892	4.2
$30,000 - $34,999	155,264	5.4	313,321	5.4	15,086	3.6
$35,000 - $39,999	135,337	4.7	292,462	5.0	12,347	2.9
$40,000 - $44,999	118,540	4.1	272,896	4.7	10,629	2.5
$45,000 - $49,999	104,778	3.7	253,328	4.4	9,028	2.1
$50,000 - $74,999	360,438	12.6	951,334	16.4	27,836	6.6
$75,000 - $99,999	169,774	5.9	480,214	8.3	13,491	3.2
$100,000 and over	202,411	7.1	587,488	10.1	23,357	5.5
Total	2,857,622	100	5,803,136	100	424,755	100

TABLE 9
Comparison of Virginia Itemized Deductions and Standard Deductions by Virginia Adjusted Gross Income Levels, Taxable Year 1997

Virginia AGI	Itemized Deductions Claimed	% of Deductions	Standard Deductions Claimed	% of Deductions
$0 - $4,999	$ 105,809,467	8.5	$1,137,134,622	91.5
$5,000 - $9,999	$ 148,454,025	15.2	$827,245,734	84.8
$10,000 - $14,999	$ 241,200,818	23.9	$768,751,994	76.1
$15,000 - $19,999	$ 321,277,450	32.0	$682,319,289	68.0
$20,000 - $24,999	$ 401,248,591	41.3	$569,260,262	58.7
$25,000 - $29,999	$ 487,434,490	51.8	$453,226,947	48.2
$30,000 - $34,999	$ 559,544,378	60.8	$360,418,225	39.2
$35,000 - $39,999	$ 602,778,819	67.6	$289,169,241	32.4
$40,000 - $44,999	$ 636,186,503	73.6	$227,681,007	26.4
$45,000 - $49,999	$ 654,361,299	78.7	$177,007,060	21.3
$50,000 - $74,999	$3,130,620,730	89.0	$387,353,543	11.0
$75,000 - $99,999	$2,168,287,884	96.9	$ 70,191,118	3.1
$100,000 and over	$4,565,710,687	99.4	$ 27,344,425	0.6
Total	$14,022,915,141	70.1	$5,977,103,467	29.9

Issues

Marriage Penalty

The standard deduction for single taxpayers in Virginia is $3,000, while the standard deduction for married taxpayers is $5,000. Some believe that this preferential treatment for single taxpayers is in effect a penalty on persons for getting married. Others argue that married persons are generally financially better off than single persons because they can combine their incomes, and, therefore, married persons do not need the tax benefits provided by the standard deduction as much as single taxpayers. This issue has been described as the "marriage penalty" debate.

In the late 1990s, several bills, which would have eliminated the marriage penalty, have been introduced for consideration by the General Assembly. None of these bills has passed both houses of the General Assembly. On June 7, 2001, President Bush signed into law the Economic Growth and Tax Relief Act of 2001. Under the Act, the federal marriage penalty (the federal standard deduction in 1999 was $4,300 for individuals and $7,200 for married persons) is fully repealed beginning January 1, 2009.

Retirement Income: *Harper* Decision

In 1985, a retired federal civil service employee in Michigan filed a lawsuit challenging the state's practice of taxing federal retirees' pensions while exempting state retirees' pensions. In 1989, the United States Supreme Court ruled in *Davis v. Michigan* that this practice violated the intergovernmental tax immunity doctrine. Twenty-three states, including Virginia, had a similar tax scheme.

In order to comply with the *Davis* decision, a special session of the Virginia General Assembly was held in 1989 to change the law so that federal and state retirees' pensions were taxed equally. The General Assembly did not, however, address the issue of refunding the state income taxes paid by federal retirees between 1985 and 1988. This prompted the filing of *Harper, et al v. Virginia Department of Taxation* on May 31, 1989. Although the Virginia Supreme Court refused to apply *Davis* retroactively, the United States Supreme Court subsequently ruled in *Harper* that *Davis* must be applied retroactively. However, the Supreme Court refused to enter judgement for the petitioners, stating in its opinion that "federal law does not necessarily entitle them to a refund." Instead, the case was remanded back to the Virginia Supreme Court to "provide relief consistent with federal due process principles," which the Supreme Court suggested could be satisfied by the availability of a predeprivation hearing.

Presently, Virginia has reached a settlement agreement with the vast majority of federal retirees who were in the same shoes as the plaintiffs in the *Harper* litigation. However, a *Harper*-like action, *Frank Almeter et al v. Virginia Department of Taxation*, was filed in 2000 seeking a refund of Virginia state income taxes. The *Almeter* plaintiffs (the federal retirees) contend that increases in the retirement benefits granted to state and local retirees beginning in 1994 were made to reimburse or make whole state and local retirees for the taxation of their pensions. The *Almeter* plaintiffs argue that because federal retirees did not receive an equivalent sum to make them whole for the taxation of their pensions, the *Almeter* plaintiffs are paying income tax on their pensions at a higher rate of tax when compared to state and local employees. They argue this practice also violates the intergovernmental tax immunity doctrine.

At the time of publication of this guide, the potential exposure to the Commonwealth is unknown.

Local Income Taxes

Until the 1989 Session, the Virginia individual income tax has been segregated for the exclusive use of the state. However, the 1989 Session enacted legislation that allowed the Northern Virginia jurisdictions, as well as the City of Norfolk, to impose up to a one percent local income tax. The legislation requires passage at a local referendum and restricts the use of the revenue to transportation purposes.

Among the 40 states that have a broad-based income tax, 14 states allow at least some of their localities to impose a local tax.[9] In 1995-1996, the local governments in these 13 states (excluding Virginia) collected approximately $12.6 billion in local income tax revenue, or about 8.6 percent of total state and local individual income tax revenue.[10] Of these states, however, the local governments in Maryland, New York, Pennsylvania, and Ohio collected over 86.1 percent of this $12.6 billion total. As a result, it is fair to say that except for these four states, local governments rely very little on an income tax.

Over-Withholding

Historically, the Virginia individual income tax has over-withheld income tax revenue from taxpayers, especially those who itemize their deductions, by basing the amount withheld on the assumption that each taxpayer takes the standard deduction. This system is identical to the federal withholding system, except that under the federal withholding system, the taxpayer can adjust his withholding for the excess of itemized deductions by claiming additional personal exemptions. In the Commonwealth, this can only be done if the taxpayer requests permission, in writing, from the State Tax Commissioner. According to the State Tax Commissioner, very few taxpayers request this authority.

To address the over-withholding problem, the 1989 Session of the Virginia General Assembly adopted legislation (Chapter 289, *Acts of Assembly, 1989*) to allow taxpayers to claim additional personal exemptions when determining withholding. This procedure more closely aligns withholding to income tax liability. However, since the passage of the 1989 legislation, Virginia has continued to defer conforming its withholding structure to the federal structure by delaying the implementation date of the 1989 legislation.

Adjusting withholding is optional for the taxpayer. Some taxpayers choose not to change their withholding because they view withholding as a form of forced savings.

Rising Cost of Health Care

Some believe that the rising cost of health care, especially prescription drugs and medical treatments not covered by insurance, can conceivably wipe out the savings of many individuals who are heavily dependent on health care. Health care costs generally are reimbursable only to the extent that they exceed 7.5 percent of federal adjusted gross income.[11] Because of this high floor, many individuals cannot itemize or deduct unreimbursed health care costs on their federal or state income tax returns. As a result, health care expenditures not covered by insurance generally must be paid-out-of pocket. The General Assembly began to address this issue in 1999 when it passed legislation allowing an income tax deduction for the cost of long-term health care insurance

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[9] Alabama, Delaware, Indiana, Iowa, Kentucky, Maryland, Michigan, Missouri, New Jersey, New York, Ohio, Pennsylvania, Virginia. Source: *U.S. Bureau of the Census*, 1995-1996.
[10] *Id*.
[11] Internal Revenue Code § 213.

premiums. Long-term health care insurance covers the nursing and other costs associated with caring for the elderly and other individuals with long-term illnesses. As the cost of health care continues to rise, the question of how to pay for or reimburse these costs may be a topic of much discussion.

Indexing

The federal Tax Reform Act of 1986 restructured the federal individual income tax by broadening the tax base, reducing individual income tax rates, and attempting to simplify the income tax, at least for moderate and lower income taxpayers who do not itemize. Another significant feature of the tax reform was that the federal income tax structure was indexed to the inflation rate.

Beginning in taxable year 1989, the federal standard deduction was indexed from the 1988 taxable year amount of $3,000 for a single person and $5,000 for a married couple. Moreover, the income tax rate structure was also indexed by adjusting the break points of taxable income that separate the 15 percent, 28 percent and 33 percent rate brackets. Also, since taxable year 1990, personal and dependent exemptions have been indexed from the 1989 amount of $2,000 per taxpayer, spouse, and dependent.

Proponents of indexing argue that it prevents taxpayers from paying progressively higher income tax rates on income increases that are strictly caused by inflation.

Standard Deduction

	Single	Married	
Federal	$3,000	$5,000	1988
	$4,300	$7,200	Indexed, 1999
Virginia	$3,000	$5,000	1989 and after

The Virginia standard deduction for 1999 equals the federal deduction for 1988. As federal indexing of the standard deduction causes it to increase, the future costs of conforming to the federal standard deduction amount would be significant for Virginia. Currently, 12 states conform their standard deduction to the federal level.

The Virginia personal exemption amount is in sharp contrast to the federal personal exemption amount.

Personal and Dependent Exemption

Federal	$2,000	1989
	$2,750	Indexed, 1999
Virginia	$800	1988 and after

The federal personal exemption amount is significantly greater than Virginia's. This disparity will continue to increase as inflation automatically increases the federal personal exemption amount. Currently, nine states (Colorado, Idaho, Maine, Minnesota, New Mexico, North Dakota, Rhode Island, South Carolina, and Vermont) conform their personal exemption amounts to the federal level.

The federal tax rate structure is also indexed. Since Congress accepted the premise for indexing, the rate structure is indexed to prevent inflation alone from pushing a taxpayer into a higher tax bracket. A number of states have also indexed their income tax rate structures.

Valid arguments against indexing exist. For example, indexing reduces the ability of states to change personal exemption amounts, standard deductions, and tax rate schedules on an ad hoc basis to respond to available revenue and current conditions, because revenues are automatically used for indexing. Moreover, indexing could reduce revenues, thereby obstructing modifications to another tax that may be in more critical need of amendment. Indexing does lead to a loss of state revenue, even during those times when a state can least afford tax revenue loss. Finally, even if the arguments for indexing at the federal level are valid, there is little concern with pushing a taxpayer into a higher tax bracket in Virginia: Virginia's top tax rate of 5.75 percent remains small compared to the top federal rate of 39.6 percent, and a move to a higher bracket in Virginia means only a one percent or two percent tax increase.

Conforming to Federal Personal Exemptions and Standard Deductions

In the early 1970s, when Virginia conformed its income tax to the federal income tax, Virginia also conformed its personal exemption amount and standard deduction amount to the federal amounts. At that time, the federal personal exemption amount was $600, and the standard deduction amount was 15 percent of AGI, with a minimum standard deduction of $1,300 and a maximum standard deduction of $2,000. This conformance of Virginia's deductions ended in 1975, when Virginia froze the personal exemption and standard deduction amounts at the level that existed as of December 31, 1974. During the 1975 Session, the standard deduction and personal exemption amounts were frozen for one year only; during the 1976 Session, these amounts were frozen permanently.[12] From 1975 until the Virginia Tax Reform Act of 1987, the personal exemption and standard deduction amounts were fixed at the 1974 amounts.

The Virginia Tax Reform Act of 1987 significantly changed the personal exemption and standard deduction amounts as well as the tax rate structure.[13] This legislation increased the personal exemption amount from $600 to $800; increased the standard deduction from a maximum of $2,000 to a flat $3,000 for single taxpayers and $5,000 for married couples; and expanded the 5 percent rate bracket for taxable income from $5,000 - $12,000 to $5,000 - $17,000 beginning in 1990.

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[12] Chapter 46, *Acts of Assembly*, 1975; Chapter 528, *Acts of Assembly*, 1976.
[13] Chapter 9, *Acts of Assembly*, 1987.

Decrease in the Top Marginal Rate

Since the passage of the Federal Tax Reform Act of 1986, which broadened the income tax law by reducing or eliminating various exemptions, deductions, and write-offs and lowering the top tax rate, a number of bills have been introduced in Virginia to lower the top tax rate from 5.75 percent. Since 1993, of the 40 states that had a broad-based income tax, 34 enacted significant income tax reform legislation. Of those 34 states, 20 lowered their top individual income tax rate. Many states lowered their top rate significantly, although it should be clearly noted most of these states still have top marginal rates above Virginia's 5.75 percent.

Proponents of a decreased top marginal tax rate argue that by broadening the tax base, the taxpayers most affected have been those with middle and upper incomes. They argue the Virginia Tax Reform Act of 1987 made a number of equity changes in the tax, but they generally benefited taxpayers who do not itemize. They believe the only way to provide significant relief to itemizers, while still retaining conformity, is to simply lower the top rate as many other states have done.

Others argue that the top rate should not be lowered and that any available money should be used for some other modifications. They contend that because the personal exemption and standard deduction amounts have been frozen since 1989, while taxpayers who itemize have been free to increase their itemized deductions to decrease their tax liability, it is only appropriate to increase those amounts that were frozen for such a long period of time.

Tax Relief Act of 2001

Virginia is one of 35 states that, in one form or another, conforms its individual income tax laws with federal individual income tax laws. As discussed above, this means that (i) Virginia applies the federal definition of "income" and other terms in administering its individual income tax laws; and (ii) the starting point for calculating Virginia individual income tax is the income amount (federal adjusted gross income) reported on the taxpayer's federal income tax return. Thus, any changes to federal adjusted gross income will also impact Virginia's income tax revenues.

On June 7, 2001, President Bush signed into law the Economic Growth and Tax Relief Act of 2001. Many provisions of the Act operate to reduce federal adjusted gross income. For example, for purposes of computing federal adjusted gross income, the Act (i) provides a new deduction up to $3,000 per year for qualified higher education expenses; (ii) expands the current deduction for interest paid on certain educational loans; (iii) increases the annual amount that currently may be deducted for contributions to Individual Retirement Accounts (IRAs); and (iv) defers the tax on certain salary and other compensation that is contributed to Internal Revenue Code § 401 (k) (employer matching contribution plans) and § 457 (state and local government deferred compensation plans) retirement savings plans. These provisions are expected to significantly reduce federal individual income tax revenues and could also lead to a significant reduction in Virginia's individual income tax revenues.

Summary

The Virginia individual income tax continues to be the largest source (63.3 percent) of general fund revenue to the Commonwealth. It generated more than $6.8 billion in the past fiscal year and has grown at more than 10 percent annually during the past three fiscal years. However, growth in fiscal year 2001 is forecasted to be 8.6 percent, primarily due to a slowing of the economy.

As the Commonwealth becomes increasingly dependent on the individual income tax and less dependent on other state taxes, Virginia becomes more susceptible to changes in the economy. This is because the Commonwealth's revenue base is becoming less diversified and heavily reliant on a single source of revenue.

Indeed, the more the Commonwealth becomes reliant on individual income taxes, the General Assembly has less flexibility to make major tax changes. Any major modifications would most likely impact the Commonwealth's largest source of tax revenue, the individual income tax.

Virginia Sales and Use Tax

Virginia Sales and Use Tax

History

The Virginia retail sales and use tax was enacted in 1966 and contained the following provisions:

1. Authorized the levy of a two percent general sales and use tax on the sales price of each item sold at retail in the Commonwealth;

2. Authorized localities to levy an additional one percent local sales and use tax using the same state sales tax base;

3. Authorized the simultaneous collection of the state and local tax by the Department of Taxation and the remittance of the local share to each county, city, or town, based upon the point of collection; and

4. Provided that half of the two cents state tax would be returned to localities for educational purposes, based upon school-age population of the respective counties and cities.

The retail sales and use tax was enacted to provide revenue to the Commonwealth and its localities at the lowest tax rate consistent with the Commonwealth's budget demands. The tax was originally intended to be a broad-based tax with a limited number of exemptions to ensure ease of administration and compliance.[1]

The state sales tax rate has been increased only twice since the sales tax was enacted in 1966, increasing from two percent to three percent in 1968 and to 3.5 percent in 1987 to meet the transportation needs of the Commonwealth. Currently, the sales and use tax rate is 4.5 percent (state rate of 3.5 percent and local rate of one percent), which is levied on the gross sales price of each item of tangible personal property sold at retail in the Commonwealth.[2] Although the General Assembly has considered legislation to authorize localities to increase the local sales and use tax rate in order to provide additional revenues for local governments, all of these bills have been defeated. Virginia's state 3.5 percent sales and use tax rate is lower than the rate of any of the other 44 states imposing such a tax, except Colorado (2.911 percent).

Table 1 shows the revenue generated by the sales and use tax for the Commonwealth and its localities for fiscal years 1990 through 2000.

TABLE 1
State and Local Retail Sales and Use Tax
Fiscal Years 1990 - 2000

Fiscal Year Ending June 30	State Sales and Use Tax[3]	Percentage Change	Local Sales and Use Tax
1990	$1,608,231,078		$472,023,633
1991	$1,674,566,335	+4.1%	$491,496,790
1992	$1,574,218,000	-6.4%	$458,617,000
1993	$1,679,895,000	+6.7%	$482,585,000
1994	$1,795,183,000	+6.9%	$522,998,000
1995	$1,935,237,000	+7.8%	$561,707,000

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[1] Address by Governor Godwin to the 1966 General Assembly, *House Journal* (January 17, 1966).

[2] See the section in this chapter titled *Food and Non-prescription Drugs* regarding the reduced sales tax on food.

[3] Based on a rate of 3.5 percent that includes the portion distributed to the Transportation Trust Fund.

TABLE 1 (CONTINUED)

1996	$2,010,402,000	+3.9%	$581,227,000
1997	$2,133,947,000	+6.1%	$618,188,000
1998	$2,240,174,000	+5.0%	$645,109,000
1999	$2,410,366,000	+7.6%	$695,425,000
2000	$2,574,006,000	+6.8%	$735,246,000

SOURCE: Virginia Department of Taxation.

The Sales Tax

State Sales and Use Tax Distribution

Retail sales and use tax revenues comprise approximately 20 percent of the Commonwealth's general fund revenues, the fund's second largest tax revenue source.

The state sales and use tax revenues collected pursuant to the 3.5 percent state tax rate are apportioned to the state and local governments and the Transportation Trust Fund according to the following formula:

1. The entire portion of the sales and use tax revenues generated by the 0.5 percent increase enacted at the 1986 Special Session is distributed to the Transportation Trust Fund.[4] For fiscal year 2000, this increase generated $372,473,000, a portion of which must be distributed according to subsection A of § 58.1-638 of the Code of Virginia, as follows:

   a. 4.2 percent to the Commonwealth Port Fund (for FY 2000, $15,643,866);
   b. 2.4 percent to the Commonwealth Airport Fund (for FY 2000, $8,939,352); and
   c. 14.7 percent to the Commonwealth Mass Transit Fund (for FY 2000, $20,019,384).

   The remaining revenues are retained in the Transportation Trust Fund.

2. According to subsection D of § 58.1638 of the Code of Virginia, state tax revenues generated by one percent of the 3.5 percent tax rate are distributed to counties and cities of the Commonwealth on the basis of the number of school-age children in each locality according to the most recent statewide census of school-age population taken by the Department of Education. The state revenues distributed to each locality during fiscal year 1999 are listed in Table 2, and the revenues must be used for the maintenance, operation, capital outlay, debt, and other expenses incurred in the operation of public schools. The total share of the state sales and use tax distributed to localities for fiscal year 1999 was $677,083,636 (see Table 2). The counties of Chesterfield, Fairfax, Henrico, and Prince William and the cities of Chesapeake, Norfolk, Richmond, Virginia Beach, and Newport News received the largest portion

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[4] Va. *Code* § 58.1-638 (2000).

of the state sales and use tax revenues, since these localities have the largest school-age populations in the Commonwealth.

3. Sales tax revenues generated by two percent of the 3.5 percent tax rate are allocated for the general purposes of state government.[5]

Local Option Sales Tax Distribution

The one percent local sales tax collected with the state tax is distributed to counties and cities based upon the point of sale.[6] The revenues collected are distributed to the general fund of the locality and may be used for any purpose. Table 3 indicates the actual amount of revenues the Department of Taxation collected and distributed to localities for fiscal year 1999. According to the Virginia Department of Accounts, the total amount of local sales tax distributed to localities in fiscal year 1999 was $692,239,271.[7]

Towns located within a county do not have authority to levy the local sales tax unless the county has not levied the tax. However, the town is entitled to a portion of the local revenues collected. One-half of a county's collections is divided between the county and the towns within the county, based upon the ratio that the town's school-age population bears to the county's school age population according to the latest statewide school census.[8]

The Use Tax

The 4.5 percent use tax rate is identical to the sales tax rate, and includes a 3.5 percent state use tax and one percent local use tax rate. The use tax is levied upon the use or consumption of tangible personal property in Virginia or the storage of tangible personal property outside the state for use or consumption in the state. A transaction subject to the sales tax is not subject to the use tax. *The primary purpose of the use tax is to prevent Virginia retailers who must collect the sales tax from being placed at a competitive disadvantage with retailers from outside the state.*[9] When states first enacted sales taxes, consumers would purchase goods from outside the state to avoid payment of the state sales tax.

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[5]Va. *Code* § 58.1-638 (2000) does not specifically provide for this allocation; however, by process of elimination it is understood that the two percent is allocated for general fund purposes.

[6]Va. *Code* § 58.1-605 (2000).

[7]This figure includes $12,349,403 distributed to towns that are not shown in Table 3.

[8]Va. *Code* § 58.1-605 (2000).

[9]*Commonwealth Department of Taxation v. Miller-Morton Co.*, 220 Va. 852, 263 S.E.2d 413 (1980).

TABLE 2
State Sales and Use Tax Portion Distributed to Localities

County	Share of Sales & Use Tax FY 1999	County	Share of Sales & Use Tax FY 1999	City	Share of Sales & Use Tax FY 1999
Accomack	$2,824,500	King & Queen	$499,623	Alexandria	$7,342,696
Albemarle	6,860,648	King William	1,250,312	Bedford	976,147
Alleghany	1,317,096	Lancaster	809,439	Bristol	1,454,680
Amelia	1,195,579	Lee	2,642,728	Buena Vista	620,135
Amherst	2,771,776	Loudoun	12,929,934	Charlottesville	3,746,417
Appomattox	1,335,173	Louisa	2,378,104	Chesapeake	22,292,712
Arlington	10,940,481	Lunenburg	1,262,865	Clifton Forge	399,196
Augusta	6,419,273	Madison	1,215,163	Colonial Heights	1,715,790
Bath	447,401	Mathews	787,847	Covington	512,176
Bedford	4,544,809	Mecklenburg	3,164,444	Danville	5,906,595
Bland	637,207	Middlesex	850,614	Emporia	579,462
Botetourt	2,783,325	Montgomery	5,679,128	Fairfax	1,556,111
Brunswick	1,539,039	Nelson	1,312,074	Falls Church	888,776
Buchanan	2,543,305	New Kent	1,383,880	Franklin	909,866
Buckingham	1,328,143	Northampton	1,606,325	Fredericksburg	1,695,704
Campbell	5,023,844	Northumberland	980,666	Galax	533,768
Caroline	2,240,017	Nottoway	1,531,507	Hampton	15,658,024
Carroll	2,570,923	Orange	2,368,563	Harrisonburg	2,034,142
Charles City	556,866	Page	2,037,155	Hopewell	2,272,153
Charlotte	1,186,039	Patrick	1,548,579	Lexington	398,192
Chesterfield	30,648,211	Pittsylvania	6,803,405	Lynchburg	7,010,786
Clarke	1,057,995	Powhatan	1,791,110	Manassas	3,520,959
Craig	466,984	Prince Edward	1,664,070	Manassas Park	962,087
Culpeper	3,328,642	Prince George	3,184,530	Martinsville	1,708,258
Cumberland	873,210	Prince William	28,323,334	Newport News	21,329,620
Dickenson	1,875,468	Pulaski	3,342,702	Norfolk	24,558,840
Dinwiddie	2,126,535	Rappahannock	729,600	Norton	446,397
Essex	1,046,446	Richmond	735,123	Petersburg	3,380,362
Fairfax	89,695,578	Roanoke	8,566,395	Poquoson	1,435,097
Fauquier	5,344,205	Rockbridge	1,788,599	Portsmouth	10,734,607
Floyd	1,124,779	Rockingham	6,688,416	Radford	814,460
Fluvanna	1,585,737	Russell	3,311,067	Richmond	17,755,435
Franklin	4,134,566	Scott	2,548,829	Roanoke	8,349,473
Frederick	5,750,431	Shenandoah	3,268,888	Salem	2,144,612
Giles	1,530,000	Smyth	3,223,696	Staunton	1,870,949
Gloucester	4,069,791	Southampton	1,931,205	Suffolk	6,997,730
Goochland	1,279,436	Spotsylvania	8,694,439	Virginia Beach	45,204,052
Grayson	1,538,537	Stafford	10,299,257	Waynesboro	1,772,531
Greene	1,452,170	Surry	718,553	Williamsburg	509,163
Greensville	968,615	Sussex	934,470	Winchester	2,074,815
Halifax	3,831,780	Tazewell	4,904,336		
Hanover	8,281,183	Warren	2,927,437		
Henrico	24,443,349	Washington	4,799,893		
Henry	5,730,848	Westmoreland	1,648,504		
Highland	238,513	Wise	4,532,758		
Isle of Wight	2,922,416	Wythe	2,644,736		
James City	4,312,321	York	6,345,961	**All Cities**	**$234,072,975**
King George	1,697,211	**All Counties**	**$443,010,661**	**Virginia Total**	**$677,083,636**

Source: Department of Accounts

TABLE 3
Local Sales and Use Tax Portions Distributed to Localities

County	FY 1999 Local 1% Option Distribution	County	FY 1999 Local 1% Option Distribution	City	FY 1999 Local 1% Option Distribution
Accomack	$2,126,036	King & Queen	95,771	Alexandria	$18,207,898
Albemarle	8,422,245	King William	602,192	Bedford	889,094
Alleghany	499,690	Lancaster	1,096,971	Bristol	3,132,630
Amelia	413,513	Lee	841,368	Buena Vista	315,224
Amherst	1,868,943	Loudoun	20,515,836	Charlottesville	7,103,623
Appomattox	652,474	Louisa	483,623	Chesapeake	21,808,249
Arlington	25,746,876	Lunenburg	317,757	Clifton Forge	250,246
Augusta	3,281,339	Madison	532,654	Colonial Heights	5,077,749
Bath	707,125	Mathews	266,935	Covington	1,030,090
Bedford	1,650,814	Mecklenburg	2,629,055	Danville	6,354,206
Bland	159,770	Middlesex	568,682	Emporia	960,281
Botetourt	1,425,096	Montgomery	6,961,386	Fairfax	8,835,555
Brunswick	601,532	Nelson	573,432	Falls Church	2,756,213
Buchanan	1,377,442	New Kent	537,635	Franklin	1,128,006
Buckingham	343,443	Northampton	884,497	Fredericksburg	6,484,777
Campbell	2,882,761	Northumberland	453,032	Galax	1,661,496
Caroline	834,890	Nottoway	973,355	Hampton	12,132,758
Carroll	1,016,115	Orange	1,366,428	Harrisonburg	7,889,926
Charles City	149,268	Page	1,059,849	Hopewell	1,631,963
Charlotte	416,059	Patrick	622,972	Lexington	554,028
Chesterfield	25,027,986	Pittsylvania	1,535,750	Lynchburg	10,215,632
Clarke	490,575	Powhatan	707,371	Manassas	3,330,133
Craig	77,527	Prince Edward	2,114,962	Manassas Park	1,064,813
Culpeper	3,634,479	Prince George	877,372	Martinsville	2,029,375
Cumberland	270,453	Prince William	26,509,958	Newport News	14,717,365
Dickenson	535,356	Pulaski	2,314,532	Norfolk	22,321,370
Dinwiddie	1,147,276	Rappahannock	279,888	Norton	1,238,607
Essex	1,206,412	Richmond	1,221,812	Petersburg	2,566,253
Fairfax	116,673,000	Roanoke	6,558,991	Poquoson	316,814
Fauquier	3,941,306	Rockbridge	1,538,284	Portsmouth	4,481,970
Floyd	391,407	Rockingham	3,210,427	Radford	799,506
Fluvanna	442,938	Russell	1,176,557	Richmond	25,562,064
Franklin	2,618,730	Scott	1,180,515	Roanoke	16,742,109
Frederick	4,258,740	Shenandoah	2,247,488	Salem	4,881,461
Giles	1,044,827	Smyth	1,925,316	Staunton	3,277,298
Gloucester	2,108,124	Southampton	326,604	Suffolk	3,515,165
Goochland	892,802	Spotsylvania	7,279,894	Virginia Beach	36,752,902
Grayson	385,810	Stafford	4,714,669	Waynesboro	2,472,611
Greene	548,152	Surry	221,154	Williamsburg	3,655,470
Greensville	293,019	Sussex	485,748	Winchester	6,836,118
Halifax	2,418,447	Tazewell	4,166,420		
Hanover	9,510,319	Warren	1,946,500	**All Cities**	**$274,981,048**
Henrico	39,123,032	Washington	4,577,579		
Henry	3,851,181	Westmoreland	660,984		
Highland	70,996	Wise	2,550,141		
Isle of Wight	1,651,428	Wythe	2,401,682	**Virginia Total**	**$687,263,175**
James City	6,059,901	York	4,328,961		
King George	589,486	**All Counties**	**$412,282,127**		

Source: Department of Accounts

Retailers within a state had to charge higher prices than out-of-state merchants or absorb the tax cost themselves. In Virginia, retailers are prohibited from advertising, directly or indirectly, that they will absorb the sales or use tax.

Because of practical and legal factors (see discussion below), use tax is not ordinarily collected by out-of-state sellers. Accordingly, individual income taxpayers are required to declare use tax owed annually when they file their income tax returns with the Department of Taxation. They must either file Form CU-7, or elect to have the amount owed deducted from their income tax refund. The amount paid by these methods in 1998 totaled $744,000, and in 1999 totaled $689,920. Prior to 1995 individuals were exempt from use tax on annual purchases from mail-order companies totaling $25 or less. In 1995, this amount was increased to $100 and made applicable to businesses in addition to individuals.

The Department of Taxation currently has three major programs aimed at collecting unpaid use tax from individuals. The first program simply attempts to encourage out-of-state dealers without physical presence in Virginia to voluntarily collect and remit use tax on purchases made by Virginians, with the department agreeing not to institute any audits or collection actions for prior periods.

The second program is directed at out-of-state furniture purchases, particularly in North Carolina. Typically, Virginia residents contact North Carolina furniture dealers who arrange shipment of their untaxed purchases directly into Virginia. Although the Virginia purchaser technically is liable for the use tax on such purchases, very few North Carolina dealers have agreed to register with the department and collect the tax. Accordingly, many such purchases could go undetected.

Therefore, the department obtains records from trucking companies from which it can identify the furniture purchases made by Virginia residents and assess use tax on untaxed property sold by North Carolina dealers. Table 4 depicts annual revenues collected as a result of this program for the period 1990 through 1999.

TABLE 4

Year Received	Total Collected
1990	$144,870
1991	$139,870
1992	$193,310
1993	$436,980
1994	$277,370
1995	$382,520
1996	$267,080
1997	$281,850
1998	$489,710
1999	$826,010

Source: Department of Taxation

The department's third program, designed to collect undeclared use tax from individuals, focuses on the purchase of all terrain vehicles (ATVs) and similar equipment, both outside and inside Virginia. Regarding out-of-state purchases, Tennessee, Kentucky, and West Virginia exempt the purchase of ATVs from their sales and use tax. Virginia residents go into these states and purchase ATVs exempt of the tax and bring them back to Virginia. Based on sales information provided by out-of-state dealers and through information-sharing arrangements with these states' tax departments, letters are sent to Virginia residents who purchase ATVs tax-free outside Virginia.

The focus on in-state sales is in reviewing exemption certificates provided by purchasers to in-state dealers. For example, if a purchaser offers an exemption certificate declaring that the ATV is purchased for farm use (an exempt activity), the department sends a letter asking the purchaser to substantiate the exemption (e.g. to show that the purchaser is a farmer). In many instances, it is discovered that the purchaser does not qualify for the exemption and a use tax assessment is issued. Table 5 shows, for the period 1997 through 1999, annual revenues collected pursuant to this two-part program aimed at in-state and out-of-state sales of ATVs and similar equipment.

TABLE 5

Year Received	Total Collected
1997	$8,950
1998	$153,630
1999	$274,860

Source: Department of Taxation

Use tax revenues collected from businesses are much greater than those collected from individuals. Table 6 shows the total amount of use tax "voluntarily" declared by businesses on their income tax returns for FY 1998 through FY 2000.

TABLE 6

Fiscal Year	Total Collected
1998	$22.3 million
1999	$29 million
2000	$32.8 million

Source: Department of Taxation

In addition to the purchase of "big ticket" items by businesses, one reason for the relatively high amount of use taxes "voluntarily" paid by businesses is that, unlike individuals, businesses have been routinely audited for use tax compliance since 1966, when the sales and use tax was first enacted. That is, the degree of voluntary tax compliance often is directly proportional to the degree to which the taxpayer perceives that noncompliance will be discovered.

Dealers' Compensation

Every retail dealer is required to collect the sales and use tax from the purchaser and remit the taxes collected to the Department of Taxation on or before the 20th day of each month following the month of collection. The department may require a dealer to file returns on a quarterly basis to simplify administration of the sales tax.[10]

As compensation for collecting the sales and use tax, dealers are entitled to a discount in the form of a deduction from the amount of state sales tax remitted to the Department of Taxation.[11] A dealer is not entitled to a discount on the additional 0.5 percent state tax levied for appropriation to the Transportation Trust Fund or on the one percent local sales tax.[12] The amount of the discount is based on a sliding scale, ranging from a minimum of two percent to a maximum of four percent, depending upon the dealer's monthly taxable sales, with the dealer discount rate reduced as the dealer's taxable sales increase.

The primary reason for providing a discount is to compensate dealers for the increased administrative costs of collecting the sales and use tax. Because these costs do not increase as taxable sales increase, small dealers incur greater administrative costs as a percentage of taxable sales when collecting the sales tax. Accordingly, the sliding scale method for computing the discount gives small dealers a greater discount.

Penalties

Dealers are subject to civil and criminal penalties for failing to collect sales tax. If a dealer fails to file a return and pay the total amount of sales tax due, the dealer must pay a six percent penalty in addition to the tax and interest for each month of delinquency, up to a maximum penalty of 30 percent of the amount of tax due.[13] A penalty of 50 percent of the tax will be assessed when it is found that the dealer willfully fails to file a return or willfully files a false return.

Sales taxes must be assessed by the Department of Taxation within three years from the date the taxes are due, except that taxes may be assessed within six years from the due date in cases of a false or fraudulent return with intent to evade taxes or failure to file a return.[14] Criminal liability (Class 1 misdemeanor) is imposed upon any dealer who fails to file a return, files a false or fraudulent return with intent to evade the tax, files a false or fraudulent claim for refund, or knowingly receives a false exemption certificate.[15]

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[10] Va. *Code* § 58.1-615 (2000).
[11] *Id*.
[12] Va. *Code* § 58.1-622 (2000).
[13] Va. *Code* § 58.1-635 (2000).
[14] Va. *Code* § 58.1-634 (2000).
[15] Va. *Code* § 58.1-636 (2000).

Exemptions

All tangible personal property sold or used in the Commonwealth is subject to the Virginia retail sales and use tax unless the property is exempt from taxation by statute. Sales and use tax exemptions are classified into the following categories: (1) governmental and commodities, (2) agricultural, (3) commercial and industrial, (4) educational, (5) services, (6) media-related, (7) medical-related, (8) nonprofit civic and community service, (9) nonprofit cultural organizations, and (10) miscellaneous.[16] In 1966, when the sales and use tax was enacted, only 24 exemptions were authorized to ensure a broad-based sales tax, to maximize state revenues, and to enhance compliance and administration. Initially, the sales tax exemptions were primarily designed to promote economic and industrial development, agriculture, public service corporations, and other organizations that provide broad benefits to the public.[17] Since 1966, the number of exemptions has increased from 24 to 377. The growth in the number of sales tax exemptions has occurred primarily under the category of nonprofit organizations.

Nonprofit Organizations

As a result of the increase in nonprofit organization exemptions, the General Assembly has mandated that its members follow a special process to obtain an exemption for a nonprofit entity. This process requires that a member wishing to patron a bill exempting a nonprofit organization from sales and use tax must first complete and sign a questionnaire (obtained from the Division of Legislative Services) and submit it to the Department of Taxation no later than the first day of November preceding the session at which the exemption will be sought.

Because the questionnaire seeks substantial information about the particular entity seeking the exemption, in practice the member has the entity complete the form or provide the needed information before the member signs and submits it. For example, the questionnaire asks for the entity's federal employer identification number; a three-year history of the entity's total purchases of tangible personal property; any anticipated changes in the amount of such purchases in the future; proof of the nonprofit entity's exemption under § 501 (c) of the Internal Revenue Code; and financial information such as salaries of the entity's five highest paid employees, gross revenues, and the percentage of revenues spent on administrative and fundraising activities.

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[16] See §§ 58.1-609.1 through 58.1-609.10.

[17] *Report of the Joint Subcommittee Studying Criteria for Evaluating Retail Sales and Use Tax Exemption Legislation* (Senate Document 27, 1988).

The questionnaire also asks for:

1. An estimate of state and local revenues that will be lost as a direct result of the exemption;

2. Beneficiaries of the exemption;

3. Direct or indirect local, state, or federal government assistance received by the person seeking the exemption;

4. The extent to which the person, property, service, or industry is exempt from the retail sales and use tax in other states;

5. Any external statutory, constitutional, or judicial mandates in favor of the exemption;

6. Other state taxes to which the person, property, service or industry is subject;

7. Similar taxpayers who are receiving a retail sales and use tax exemption; and

8. Other criteria, facts, or circumstances that may be relevant to the exemption request.

The Department of Taxation analyzes the information and submits a list of the entities to the Division of Legislative Services and DLS then drafts bills for the respective members. These bills, as well as most other bills granting or expanding exemptions from sales and use tax, are required to be introduced by the member no later than the first day of the session.

By statute, a nonprofit entity may receive an exemption only for purchases of tangible personal property, and only if it:

1. Is exempt from federal income taxation under either § 501 (c) (3) or § 501 (c) (4) of the Internal Revenue Code;

2. Spends no more than 40 percent of its gross revenues on general administrative and fundraising functions; and

3. Is in compliance with state laws governing the solicitation of contributions.

In addition to these three statutory factors, the General Assembly has the discretion to deny or grant any exemption on any reasonable ground, including, for example, the presence of significantly high salaries of employees.

All exemptions granted to nonprofit organizations prior to the 2001 Session of the General Assembly (except churches) expire ("sunset") on July 1, 2001, unless the exemptions were extended during the 2001 Session. Thereafter, nonprofit organizations whose exemptions were extended or newly granted during the 2001 Session will have their exemptions expire, unless extended by the General Assembly, according to the following schedule:

Type of Organization	**Expiration Date**	**Session for Extension**
Educational	July 1, 2002	2002 Session
Medical-related	July 1, 2003	2003 Session
First half of Civic and Community Service exemptions appearing in Va. Code § 58.1-609.8	July 1, 2004	2004 Session
Second half of Civic and Community Service exemptions appearing in Va. Code § 58.1-609.8	July 1, 2005	2005 Session
Cultural or Miscellaneous	July 1, 2006	2006 Session[18]

The process for obtaining extensions for these exemptions is very similar to the process described above for obtaining new exemptions.

Food and Non-prescription Drugs

In recent years, the General Assembly effectuated exemptions regarding the sale of two broad categories of goods -- non-prescription drugs and food for human consumption. In 1998, non-prescription drugs became completely exempt from sales and use taxes.[19] (The exemption for non-prescription drugs originally was enacted in 1990 to be effective July 1, 1992, but the effective date was delayed several times).[20]

In 1999, the General Assembly enacted legislation that, beginning January 1, 2000, gradually reduces the state's sales tax on food for human consumption (originally 3.5 percent), by 0.5 percent per year, to 1.5 percent on and after April 1, 2003.[21] Of the revenues generated by the fully phased-in 1.5 percent tax, two-thirds is to be paid

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[18] Va. Code § 30-19.05 (2000).

[19] Va. Code § 58.1-609.7 (15) (2000).

[20] Chapter 117 (exemption first enacted to be effective July 1, 1992), *Acts of Assembly*, 1990; Chapter 601 (effective date delayed to July 1, 1994), *Acts of Assembly*, 1992; Chapter 611 (effective date delayed to July 1, 1996), *Acts of Assembly*, 1994; Chapters 376 and 459 (effective date delayed to July 1, 1998), *Acts of Assembly*, 1996.

[21] Va. Code § 58.1-611.1 (2000).

to localities based on the localities' percentage of school-age population, and one-third is to be paid into the Transportation Trust Fund.

However, each incremental reduction in food tax is contingent on (1) actual general fund state revenues exceeding the official general fund estimates by at least one percent in the fiscal year immediately preceding the next proposed reduction; (2) the Governor, forecasting in December prior to the next proposed reduction, that future general fund revenues, excluding transfers, will exceed the prior fiscal year's actual revenues by at least five percent; (3) the Governor, forecasting in December prior to the next proposed reduction, that general fund revenues will be sufficient to cover appropriations for the fiscal years under the then current appropriation act; and (4) the Governor, forecasting in December prior to the next proposed reduction, that revenues needed to cover "car tax relief" for the next fiscal year will not exceed 8.5 percent of total general fund revenues available for appropriation.[22]

Issues

Exemptions for Nonprofit Organizations

The proliferation of sales and use tax exemptions granted over the years, prompted the General Assembly to appoint a joint subcommittee to study the issue in 1987 and 1988, and to appoint another such joint subcommittee in 1993. The reports of these subcommittees identified several problems associated with the exemptions. These problems included:

1. Erosion of a broad tax base and reduction in revenues;
2. Increased difficulty of compliance and administration;
3. Lack of uniformity as to which entities are exempt (i.e. exempt organizations often are indistinguishable from other organizations that are not exempt from a tax policy or public service viewpoint);
4. Lack of detailed information about the entities seeking exemptions, and, as a result, lack of the fiscal impact in granting the exemptions; and
5. Lack of a reliable method of on-going evaluation of entities after they receive exemptions.

The subcommittees' recommendations as adopted by the General Assembly (with additional modifications in recent years) resulted in the current process for granting exemptions as previously described. However, this process does not fully address some fundamental difficulties. First, the number of exemptions for nonprofit

[22] Va. Code § 58.1-611.1 D (2000).

entities continues to grow at a faster rate than ever, exacerbating the erosion of the tax base and increasing the difficulty in enforcement and administration.

Second, the lack of uniformity among those entities with and without exemptions continues to grow. This problem does not arise because the General Assembly lacks criteria or fails to apply the criteria fairly in acting on individual exemption bills. Rather, the problem arises because exemption bills are enacted as general legislation (as they are constitutionally required to be), but the process utilized to deal with the bills treats them as if they were special legislation for a particular entity.

For example, if the XYZ nonprofit corporation wishes to be exempt from the sales and use tax, it follows the process set out above of requesting a member of the General Assembly to sponsor legislation and providing the individualized information to the Department of Taxation. The bill for such an exemption, as general legislation, will not refer to the XYZ corporation by name, but will describe what it does (e.g. "any nonprofit corporation exempt under § 501 (c) (3) of the Internal Revenue Code; located within the boundaries of the Eighth Planning District; and organized for the purpose of aiding individuals who have multiple sclerosis").

Because such legislation is drafted to describe the XYZ corporation, it necessarily does not describe, and therefore does not exempt, equally worthy organizations. This problem has increased in recent years as exemption bills have been drawn more narrowly.

The joint subcommittee studying sales and use tax exemptions in 1993 recognized this problem in its final report:

> The specificity of exemptions, while attempting to avoid one problem inadvertently creates another. While such "narrowing" of the exempting language clearly works to reduce the Commonwealth's revenue loss, the ability of such narrow classifications to withstand scrutiny under an equal protection or special legislation analysis may well be suspect. In addition, exemptions of this nature also serve to encourage the proliferation of even more such narrowly drawn exemption provisions as other legislators and their constituents adopt a "me too" attitude. Such an attitude is understandable because an exemption is simply a form of a cash subsidy that all other state taxpayers support. To favor state taxpayers in one jurisdiction over those in others would seem to require, at a minimum, some compelling justification, one which is usually very difficult to articulate.

As a potential solution to this problem the subcommittee considered a statutory framework similar to North Carolina's for granting sales and use tax exemptions administratively. Under this proposal the entire process for granting exemptions would be handled by the Department of Taxation pursuant to broad standards set by the

General Assembly. The subcommittee ultimately rejected this proposal because it was feared that the revenue loss resulting from anticipated increases in the number of exemptions would be too great.

However, the proposal under consideration by the subcommittee contemplated permitting exemptions to be granted by the Department of Taxation to all organizations exempt under § 501 (c) of the Internal Revenue Code. A modified version of the proposal might reduce the fiscal impact. For example, the General Assembly could provide for the Department of Taxation to grant an exemption to any 501 (c) organization that has gross revenues less than a certain amount, or has purchases less than a certain amount.

Partial Exemption for Food

As stated, the gradual, annual reduction in the state's sales and use tax on food for human consumption is contingent on several variables. In general, these contingencies are the same as the contingencies for the continuation of the car tax relief schedule, with one main difference.

One contingency for car tax relief is that actual general fund revenues must not fall below the official estimate for such revenues by more than 0.5 percent for the fiscal year immediately preceding the next proposed reduction. However, for the food tax reduction to continue, such general fund revenues must **exceed** the official estimate for such revenues by at least **one percent**.[23]

In future sessions, the General Assembly may confront whether to continue funding food tax reductions if one of the contingencies occurs. This issue may involve balancing funding for tax relief with other funding priorities.

Constitutional Issue: Internet and Mail Order Sales

In order for a state to constitutionally require an out-of-state business to collect and remit sales and use taxes, the United States Supreme Court held that the interstate commerce clause requires that the business first have sufficient "nexus" with the state in the form of some physical presence in the state (e.g. offices or employees).[24] However, the Court also held that Congress has the ultimate power to resolve such issues concerning interstate commerce. Thus, for example, Congress could enact legislation modifying the "physical presence" requirement. To date, Congress has not enacted such legislation.

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[23] Va. Code §§ 58.1-611.1 D and 58.1-3524 C (2000).

[24] *Quill Corp. v. North Dakota*, 112 S.Ct. 1904 (1992).

Accordingly, when goods are sold over the Internet or by mail, the seller cannot be required to collect and remit sales and use tax unless the seller has a physical presence in the purchaser's state. The purchaser can be held liable for payment of the use tax to his state of domicile. However, because of the practical difficulties in enforcement, a very small percentage of such taxes are collected if they are not paid to the seller.

In 1998, Congress enacted the Internet Tax Freedom Act ("ITFA")[25] that imposed a three-year moratorium on: (1) any new taxes on Internet access, (2) discriminatory taxes on electronic commerce, and (3) multiple taxes on electronic commerce. Under the Act, "multiple taxes" means any tax imposed by one state on the same electronic commerce transaction that is also subject to a tax by another state, without a credit being allowed for the amount of taxes paid in the other state.

The Act also created the Advisory Commission on Electronic Commerce that was chaired by Governor Gilmore. The Commission transmitted its report to Congress on April 3, 2000, recommending, among other things: (1) extending the moratorium on multiple and discriminatory taxation of electronic commerce for an additional five years through 2006, (2) prohibiting the taxation of digitized goods sold over the Internet, (3) establishing "bright line" nexus standards for American businesses engaged in interstate commerce, and (4) making permanent the current moratorium on Internet access taxes.

Virginia does not currently impose any taxes on Internet access. However, goods and services sold over the Internet are subject to the same rules and restrictions regarding sales and use taxes as all other goods and services. That is, the purchaser technically is liable for such tax, but the seller may not be required to collect and remit the tax unless the seller has sufficient physical presence in Virginia.

Virginia and the other states that levy a sales and use tax confront two major problems as a result of the "physical presence" requirement:

1. Out-of-state vendors receive a competitive advantage over in-state vendors, because in-state vendors must collect sales tax from their customers.

2. States lose substantial amounts of sales tax revenues because out-of-state Internet and mail order sales effectively escape taxation.

Because of the tremendous speed and magnitude of growth in Internet commerce, the impact of such commerce on sales tax revenues will continue to grow. In 1998 approximately $50 billion of goods and services were sold over the Internet in the United States. By 2003 it is estimated that this amount will increase to $1.5

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[25] 47 U.S.C. § 151, sec. 1100 et seq.

trillion. Similarly, in 1994 only 0.2 percent of households in the United States had access to the Internet. By 1996, this figure had increased to 14 percent, and in 1999 it was 37 percent.

Summary

Retail sales and use tax revenues represent the second largest source of revenues to the Commonwealth's general fund, comprising about 20 percent of the general fund. For fiscal year 2000, the state sales and use tax generated $2,574,006,000. Because sales and use tax collections are affected by economic activity, the tax rate, the number of exemptions, and administrative procedures, the recent growth in sales tax collections may be attributable to a slight rise in inflation and an increase in real spending.

Since the inception of the sales and use tax in Virginia in 1966, the number of exemptions created by the General Assembly has steadily increased. This increase has been criticized because exemptions reduce revenues by eroding the tax base and complicating tax administration. Attempts to reduce this problem include establishing a legislative procedure for considering exemption proposals to ensure strict scrutiny of each bill, and establishing a process for future review of exemptions that are granted. However, the number of exemptions has continued to grow in recent years.

Other current issues involving sales and use taxes include funding for continuation of food tax reduction and how to respond to Internet and mail-order commerce.

Corporate Income Tax

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Corporate Income Tax

History

The corporate income tax is an outgrowth of a license tax, which was a payment imposed for the privilege of doing business. The tax evolved from its earliest form when, in 1842-43, the Commonwealth imposed a 1.5 percent tax on all "dividends of profit." At that time many public service corporations had exemptions to encourage public works, and very few of the remaining corporations were profitable enough to pay dividends, with the result that very little tax revenue was generated. However, this tax formed the basis of our current net earnings tax.[1] Corporate taxation in Virginia evolved through a number of different tax philosophies during the next 70 years, including the taxation of computed

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[1]Sydenstricker, Edgar. *A Brief History of Taxation in Virginia*. Richmond: The Legislative Reference Bureau of Virginia, 1915.

rent, of gross earnings, of bonded indebtedness as a measure of wealth, and attempts to tax the owners of a corporation.[2] Since the early 1900s, however, Virginia has based its corporate income tax on net income and has focused on more accurately determining income.

The Virginia corporate income tax is the third largest source of general fund revenue, comprising approximately five percent of the Commonwealth's general fund. In fiscal year 1999, the Commonwealth collected $420.4 million from this tax, a four percent increase over the previous fiscal year. Until the 1989 Session, the corporate income tax had been segregated for state taxation only; the 1989 General Assembly, however, passed legislation that allows the northern Virginia localities, as well as the City of Norfolk, to impose up to a one percent local income tax on individuals and corporations for transportation purposes, conditional upon its approval by local referendum. Further, the local tax would expire five years after its adoption.[3] Through 2000, no locality had placed a local income tax on its ballot.

The Commonwealth's corporate income tax is the most volatile of all general fund taxes. Corporate income taxes reflect a corporation's bottom line -- profits -- which can fluctuate dramatically from year to year.

Table 1 sets forth Virginia's annual corporate income tax collections for the past 10 fiscal years and the percentage change for each year. Revenues actually decreased in four of the 10 years and increased in the remaining six years. This volatility is highlighted by the changes in collections for fiscal years 1993 and 1994 and again in 1999 and 2000. Collections increased more than 34 percent in 1993 and decreased 16 percent in 1994. Then in 1999, they dropped 6.7 percent and rose more than 34 percent in 2000. According to the Department of Taxation, a portion of the increase in 2000 is attributable to large, one-time payments by a few corporate taxpayers.

TABLE 1

Corporate Income Tax, Fiscal Years 1991 - 2000

Fiscal Year Ending June 30	Tax Collections	% Increase/Decrease from Previous Year
1991	$279,235,000	-10.0
1992	$275,865,000	-1.3
1993	$371,452,000	+34.6
1994	$312,149,000	-16.0
1995	$376,356,000	+20.6
1996	$402,337,000	+6.9
1997	$432,298,000	+7.4
1998	$450,780,000	+4.2
1999	$420,421,000	-6.7
2000	$565,909,000	+34.6

[2] *Id.*

[3] Va. Code §§ 58.1-540 through 58.1-549 (2000).

The Commonwealth's corporate income tax has grown 102.7 percent during this 10-year period, while the general fund has grown 92.7 percent during the same period. The corporate income tax has increased slightly as a component of the general fund, comprising 4.3 percent in 1991 and five percent in 2000. Too much significance should not be given to this because the growth in some years has been due to one-time payments by large corporations and receiving such payments cannot be relied on from year to year.

Virginia conformed its corporate income tax to the federal system in 1971.[4] The Virginia tax is currently imposed at a flat rate of six percent on Virginia taxable income. This rate has not changed since January 1, 1972, when it increased from five percent to the current level. Prior to 1972, the corporate income tax was last increased in 1948, when it increased from three percent to five percent.[5] Significantly, whenever a change was made to the corporate income tax rate, a change was also made in the individual income tax rate. Until 1972, the top corporate rate equaled the top individual rate; however, in 1972, the top corporate rate was increased to six percent while the top individual income tax rate was increased only to 5.75 percent.

Corporate Tax Structure

The Virginia corporate income tax applies to all domestic (incorporated in Virginia) and foreign (incorporated outside Virginia) corporations doing business in the state except:

- Public service corporations other than telecommunications corporations;
- Electric utilities, as of January 1, 2001;
- Gas utilities as of January 1, 2002;
- Insurance companies;
- Inter-insurance exchanges;
- State and national banks;
- Banking associations;
- Electing small business corporations (S corporations);
- Any company that does business on a mutual basis;
- Credit unions; and
- Religious, educational, benevolent, and other nonprofit corporations.

Corporations exempt from the corporate income tax are either exempt or subject to other forms of taxation.

Virginia's six percent corporate income tax applies to a corporation's Virginia taxable income, which is computed by using federal taxable income as the base. Most states (39 of the 45 states that impose a corporate income tax) conform their corporate tax, in general, to the federal system for much the same reason most states conform their individual income tax. For Virginia tax returns, modifications are made to federal taxable

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[4]Chapter 171, *Acts of Assembly*, 1971. This legislation was effective for taxable years 1972 and after.

[5]Chapter 139, *Acts of Assembly*, 1948.

income. These include the addition of (i) income taxes imposed by Virginia or any other taxing jurisdiction (because such income taxes are deductible when computing federal taxable income) and (ii) certain interest and dividends.

Virginia permits corporations engaged in multistate activities that have income taxable by Virginia and out-of-state political subdivisions to apportion their Virginia taxable income through the following three-factor formula, so that different states do not impose a tax on the same income:

1. **A Property Factor (25 percent):** A ratio of the average real and tangible personal property value of the firm in Virginia to the firm's total average real and tangible personal property value.

2. **A Payroll Factor (25 percent):** A ratio of the payroll in Virginia to the firm's total payroll.

3. **A Sales Factor (50 percent):** A ratio of the sales in Virginia to the firm's total sales.

These ratios are added together with the sales factor doubled and divided by a denominator of four to determine the portion of total taxable income subject to the Virginia corporate income tax. However, if there is no sales factor, then the denominator will be the number of existing factors and where there is a sales factor but no payroll or property factor, the denominator will be the existing factors plus one. All three factors do not necessarily pertain to all corporations, although this occurrence appears to be the exception rather than the rule. Also, a corporation can petition the Tax Commissioner to use a different allocation formula if the three-factor formula is inherently unfair to the particular corporation. Special apportionment factors exist for motor carriers, financial corporations, construction companies, and railway companies. A corporation's dividends are allocated to the state of commercial domicile of the taxpaying corporation. Moreover, Virginia prohibits consolidation or combination of an affiliated group that includes any controlled foreign corporation whose income derives from sources outside the United States.

A corporation's taxable year for purposes of Virginia's corporate income tax is the same as the corporation's federal taxable year. Corporations utilizing a calendar year reporting basis must file their corporate tax return by April 15 of the following year. Each corporation may elect whether to file separately, to file separately on a combined return, or to file on a consolidated return, which is a single return for a group of affiliated corporations. Once an election is made, however, it is generally irrevocable.

Comparison with Other States

Table 2 lists the corporate income tax rates in other states. Five states have no corporate income tax: Nevada, South Dakota, Texas, Washington, and Wyoming. The table also shows that 12 states impose a progressive tax rate on corporate income, while the majority impose a flat corporate income tax rate, as does Virginia. Iowa has the highest state corporate tax rate at 12 percent; North Dakota has the next highest rate, 10.5 percent; and Pennsylvania has the third highest at 9.99 percent.

An examination of this table shows Virginia's corporate income tax rate compares very favorably with the rates of other states. Of the 45 other states that impose a broad-based corporate income tax, only eight impose a lower rate than Virginia, and 29 impose a higher rate. Virginia also ranks well when comparing its corporate tax rate to the top rate of its neighboring and competing states.

State	Rate	State	Rate
Georgia	6.00%	South Carolina	5.00%
Kentucky	8.25%	Tennessee	6.00%
Maryland	7.00%	**Virginia**	**6.00%**
North Carolina	7.00%	West Virginia	9.00%

Only South Carolina has a lower corporate income tax rate than Virginia, while Georgia and Tennessee have equal rates. The remainder of Virginia's neighboring and competing states have higher rates than Virginia.

In contrast to Virginia's corporate income tax rate of six percent, the federal corporate income tax rate schedule, according to I.R.C. § 11 (b), is as follows:

Taxable Income	Rate
$50,000 or less	15%
$50,000 but not more than $75,000	25%
$75,001 but not more than $10,000,000	34%
$10,000,001 and over	35%

An additional five percent surtax applies for taxable income over $100,000, although it cannot exceed $11,750. An additional three percent surtax applies to taxable income over $15,000,000, but such a surtax may not exceed $100,000. The surtax serves to eliminate the benefit of the lower tax brackets for corporations with taxable incomes above $100,000 and $15,000,000.

As with individual income tax comparisons, it is helpful to examine corporate income tax collections on both a per capita and per $100 of personal income basis. An examination of these two measures clearly shows that Virginia places a very modest burden on its corporate citizens. Virginia collected an average of $60.29 per capita in corporate income tax in 2000 (which was 41st among the 50 states), compared to the U.S. per capita average of $112.77.

TABLE 2
State Corporate Income Tax Rates, Fall, 2000

State	Taxable Income	Rates & Minimum Tax
Alabama		5.00%
Alaska	1st $10M	1.00%
	$10-$20M	2.00%
	$20-$30M	3.00%
	$30-$40M	4.00%
	$40-$50M	5.00%
	$50-$60M	6.00%
	$60-$70M	7.00%
	$70-$80M	8.00%
	$80-$90M	9.00%
	Over $90M	9.40%
Arizona		7.968%; $50 minimum
Arkansas	1st $3M	1.00%
	2nd $3M	2.00%
	Next $5M	3.00%
	Next $14M	5.00%
	Next $75M	6.00%
	If net income over $100,000	flat 6.5%
California		8.84% (S corps - 1.5%); $800 minimum
Colorado		4.75%
Connecticut		7.50%(S corps - no tax); $250 minimum and $1M maximum
Delaware		8.70%
District of Columbia		9.5% + 2.5% surtax; $100 minimum (2.5% repealed eff. 12/31/2002)
Florida		5.50%
Georgia		6.00%
Hawaii	1st $25M	4.40%
	Next $75M	5.40%
	Over $100M	6.40%
Idaho		8.00%: $20 minimum
Illinois		4.8%
Indiana		3.40%
Iowa	1st $25M	6.00%
	Next $75M	8.00%
	Next $150M	10.00%
	Over $250M	12.00%
Kansas		4.00% + 3.35% surtax on over $50M
Kentucky	1st $25M	4.00%
	2nd $25M	5.00%
	Next $50M	6.00%
	Next $150M	7.00%
	Over $250M	8.25%
Louisiana	1st $25M	4.00%
	2nd $25M	5.00%
	Next $50M	6.00%
	Next $100M	7.00%
	Over $200M	8.00%
Maine	1st $25M	3.50%
	Next $50M	7.93%
	Next $175M	8.33%
	Over $250M	8.93%
Maryland		7.00%
Massachusetts		9.50% + $2.60 per $1,000 on tangible values or net worth ($456 minimum)
Michigan		2.10% (rate reduced by 0.1% annually until tax expires)

TABLE 2 (CONTINUED)

Minnesota		9.80%
Mississippi	1st $5M	3.00%
	Next $5M	4.00%
	Over $10M	5.00%
Missouri		6.25%
Montana		6.75% ($50 minimum)
Nebraska	1st $50M	5.58%
	Over $50 M	7.81%
Nevada	No Tax	
New Hampshire		8.00%
New Jersey		9.00%
New Mexico	1st $500M	4.80%
	Next $500M	6.40%
	Over $1 Million	7.60%
New York		8.00% (7.5% beginning 7/1/01)
North Carolina		7.00%
North Dakota	1st $3M	3.00%
	Next $5M	4.50%
	Next $12M	6.00%
	Next $10M	7.50%
	Next $20M	9.00%
	Over $50M	10.50%
Ohio	1st $25M	5.10%
	Over $25M	8.50% ($50 minimum)
Oklahoma		6.00%
Oregon		6.60% ($10 minimum)
Pennsylvania		9.99%
Rhode Island		9.00% ($250 minimum)
South Carolina		5.00%
South Dakota	No Tax	
Tennessee		6.00%
Texas	No Tax	
Utah		5.00% ($100 minimum)
Vermont	1st $10M	7.00%
	Next $15M	8.10%
	Next $225M	9.20%
	Over $250M	9.75% ($250 minimum)
Virginia		**6.00%**
Washington	No Tax	
West Virginia		9.00%
Wisconsin		7.90%
Wyoming	No Tax	

M = thousands
SOURCE: Research Institute of America, *All States Tax Guide*.

TABLE 3
State Corporate Income Tax Per Capita Collections Ranking of States

Rank	State	Per Capita
1.	Alaska	$341.91
2.	Delaware	308.58
3.	Michigan	239.88
4.	New Hampshire	212.98
5.	Massachusetts	202.37
6.	Illinois	173.47

TABLE 3 (CONTINUED)

7.	Indiana	166.52
8.	California	164.71
9.	New Jersey	163.81
10.	Minnesota	163.16
11.	New York	158.71
12.	North Dakota	147.70
13.	West Virginia	145.62
14.	Connecticut	144.58
15.	Pennsylvania	128.21
16.	Wisconsin	127.79
17.	North Carolina	120.33
18.	Maine	117.70
19.	Arizona	114.14
20.	Tennessee	104.21
21.	Georgia	101.84
22.	Montana	101.52
23.	Oregon	97.82
24.	Kansas	95.64
25.	New Mexico	94.24
26.	Utah	84.58
27.	Florida	83.84
28.	Vermont	83.70
29.	Arkansas	83.17
30.	Mississippi	82.89
31.	Iowa	81.74
32.	Nebraska	81.05
33.	Kentucky	78.79
34.	Maryland	78.31
35.	Idaho	76.81
36.	Colorado	74.22
37.	South Dakota*	69.32
38.	Rhode Island	66.93
39.	Ohio	66.77
40.	Louisiana	65.49
41.	**Virginia**	**60.29**
42.	South Carolina	59.66
43.	Oklahoma	55.78
44.	Alabama	53.33
45.	Missouri	50.57
46.	Hawaii	44.21
47.	Nevada	0
48.	Texas	0
49.	Washington	0
50.	Wyoming	0
	U.S. AVERAGE	***$112.77***

* South Dakota does not impose a general corporate income tax but limits this tax to financial institutions.

SOURCE: Calculated from data contained in *State Government Tax Collections in 1999,* U.S. Bureau of the Census.

Corporate Tax Base

For fiscal year 1999, Virginia corporations filed 151,948 returns with an actual tax liability of $419.8 million. Table 4 shows that 97 corporations with taxable incomes of greater than $10 million filed returns. These corporations comprise 0.1 percent of all corporate returns in Virginia, yet they paid 49.9 percent of the total corporate income tax. This amounts to an average payment of $2.16 million per corporation for those corporations with taxable income of greater than $10 million. The 379 corporations with taxable income of greater than $2 million but less than $10 million comprised approximately 0.2 percent of all corporate tax returns, yet they paid over 22 percent of the entire corporate income tax.

At the other end of the spectrum, almost 92.4 percent of the returns were filed by corporations with Virginia taxable income of less than $25,000, and these corporations only paid 1.8 percent of the entire state corporate tax. The average tax payments by these smaller corporations amounted to $54.25 per return. Clearly, a handful of corporations paid the lion's share of Virginia's corporate income tax, while thousands of small corporations paid either no tax or very small amounts of tax.

TABLE 4

Number of Corporate Returns by Taxable Income and Tax Assessed
Fiscal Year 1999

Taxable Income From Virginia Sources	Number of Corporate Returns	Percent of Total	Corporate Income Tax Assessed	Percent of Total
UP to $24,999	140,455	92.4	$7,619,392	1.8
$25,000 to $49,999	3,844	2.5	$8,302,822	2.0
$50,000 to $99,999	2,999	2.0	$12,616,938	3.0
$100,000 to $499,999	3,157	2.1	$41,138,356	9.8
$500,000 to $999,999	627	0.4	$26,565,602	6.3
$1,000,000 to $1,999,999	390	0.3	$32,652,422	7.8
$2,000,000 to $9,999,999	379	0.2	$94,902,464	22.6
$10,000,000 and Over	97	0.1	$209,426,109	49.9
Totals Before Adjustments	**151,948**	**100.0**	**$433,224,105**	**103.2**
Departmental Adjustments	**5,545**	**-----**	**<$13,464,632>**	**-3.1**
Totals	**151,948**	**100**	**$419,759,473**	**100**

SOURCE: Virginia Department of Taxation, *Annual Report, Fiscal Year* (1999).

Issues

Corporate Income Tax Collections

As this report has noted, the general fund has grown approximately 92.7 percent since fiscal year 1991, while the corporate income tax has grown by 102.7 percent. Virginia's increase in corporate income tax collections follows the pattern of federal corporate income tax collections. Since corporate collections are based on profits, actual collections will be volatile. For instance, look at Table 1 in this chapter to see the extreme differences in each year's collections from 1991 through 2000. Moreover, corporate profits generally do not grow as quickly as personal income; therefore, growth in corporate tax collections will continue to lag behind individual income tax collections.

Broadening of the Corporate Income Tax

The corporate income tax extends to all corporations organized under the laws of the Commonwealth and all foreign corporations having income from Virginia sources, with the following exceptions:

- Public water companies and telegraph companies (currently there is only one telegraph company). Effective in 2001 and 2002, electricity and gas firms, respectively, are being phased into a corporate income tax from a gross receipts tax basis.
- Insurance companies that pay a gross receipts license tax based on gross receipts.
- Banks, banking associations, and trust companies that pay a bank franchise tax on net capital.
- S corporations, which pay an individual income tax when the proceeds are distributed to the stockholders of the subchapter S corporation.
- Credit unions.
- Nonprofit corporations.

These exempted corporations make up a significant percentage of all corporations. It could be argued that these corporations were either different or regulated and therefore not typical corporations striving to maximize profits. However, as the economy has changed, and with less regulation and an increase in the diversity of corporations into other areas, some argue that there is less justification for treating one corporation differently from another for tax purposes.

One example may be the finance industry, which is in part comprised of banks, savings and loan associations, and credit unions. (For purposes of this analysis we exclude brokerage firms, which offer savings and loan services.) To some extent, these different types of corporations provide at least a limited number of identical services. For example, all these institutions provide charge cards, savings accounts, certificates of deposit, consumer loans, and home equity loans. Yet, in terms of taxes, they are treated quite differently. Banks pay a bank franchise tax on net capital; savings and loan associations pay a corporate income tax (although Virginia does not conform in the area of bad debt deductions); and credit unions, organized on a nonprofit basis, pay no state tax, since they have no profit.

Another example is the insurance industry. Insurance companies are a large industry in Virginia, and they pay taxes on a gross receipts basis. In fact, in the last fiscal year the gross receipts tax on insurance companies approaches one-half of the total corporate income taxes paid by all other corporations in the Commonwealth and in past years has exceeded one-half ($251 million collected in insurance premium taxes in fiscal year 2000 versus $566 million collected from the corporate income tax).

There is also a growing trend for nonprofit organizations to compete with for-profit corporations. For example, credit unions compete with savings and loan associations and banks. When the General Assembly passed legislation in the 1988 Session to begin to tax telecommunications companies on the basis of corporate profits rather than gross receipts, a minimum tax of 0.5 percent was imposed on nonprofit corporations so that nonprofit telecommunications companies would at least pay some state tax. Likewise, when electric utility companies begin to pay corporate income tax in 2002, nonprofit electric co-ops will pay tax on unrelated business income so they may pay some state tax.

Depreciation

One of the most often discussed areas of the corporate income tax has been the tax treatment of depreciation, fueled in large part by the numerous changes in this area made by the federal government. Generally, these changes have been made either to generate taxes or to stimulate investment. Since depreciation is such an important factor in determining corporate profits, federal changes in depreciation schedules significantly affect Virginia's corporate tax revenues.

Because Virginia conformed its corporate income tax, it also has conformed to federal depreciation. In 1982, when the federal government accelerated depreciation by instituting the Accelerated Cost Recovery System (ACRS), Virginia deconformed to federal depreciation by requiring corporations to defer a percentage of ACRS for five years. This deconformity was terminated by the Virginia Tax Reform Act of 1987, which again conformed Virginia's depreciation to the federal, beginning in taxable year 1988.

The general principle of conformity has never been seriously questioned; however, the specific issue of conformity to federal depreciation has surfaced in the past and may again in the future, especially if significant changes occur at the federal level.

Summary

Although the Virginia corporate income tax remains a major source of general fund revenue to the Commonwealth, it's volatility makes it difficult to count on from year to year. As with the Virginia individual income tax, the corporate income tax generally conforms to the federal income tax system, and benefits from federal rules, regulations, and audits. The corporate income tax is the most volatile component of the general fund, since it depends on net corporate profits.

Virginia's six percent corporate tax rate compares favorably to other states; and comparisons of states' corporate income tax collections, on a per capita basis, reveal that Virginia's tax burden is quite low.

ABC Taxes

History

Current System of Taxing

Disposition of ABC Tax Revenues and Net Profits

Comparison with Other States

Issues

Privatization
Efficiency and Expansion

Summary

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ABC Taxes

History

On August 17, 1933, Governor Garland Pollard convened the Virginia General Assembly in a special session to respond to federal legislation legalizing the sale and taxation of beer and repealing the 18th Amendment to the United States Constitution.[1] The Virginia General Assembly enacted the following legislation at the 1933 Special Session:

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[1] Address of Governor Pollard to the General Assembly (August 17, 1933).

1. Legalized the sale of beer and imposed a state excise tax of $2.75 per 31-gallon barrel on manufacturers and bottlers and a one-cent tax on beverages in 12-ounce bottles;

2. Authorized a general referendum on the question of ratifying the repeal of the 18th amendment; and

3. Established a joint subcommittee, the Liquor Control Committee, to examine and propose a plan for liquor control in the Commonwealth in case the 18th Amendment was repealed.[2]

On October 3, 1933, Virginia voted to repeal the 18th Amendment and to establish a plan of liquor control in the Commonwealth. On December 5, 1933, the 18th Amendment was officially repealed by ratification of the 21st Amendment, and national prohibition ended.[3]

On December 13, 1933, the Liquor Control Committee submitted its report to the General Assembly of Virginia and recommended adoption of the Virginia Alcoholic Beverage Control Act. The act authorized the state government, through the Alcoholic Beverage Control Board, to sell liquor at retail and to regulate the hours and conditions of alcoholic beverage sales. The legislation authorized private licensees to sell wine and beer for on-premises or off-premises consumption, depending on the type of license. Additionally, the act included a local option provision, which allowed any political subdivision of the state to petition the local court for a referendum on the question of whether the sale of alcoholic beverages should be permitted in the county, city, or town.

Nationally, revival of the liquor industry was viewed as an essential tool to economic recovery in the United States because new jobs would be created, purchasing power would increase, and new taxes would generate revenues for federal, state, and local governments to provide needed services.[4] In setting tax rates on alcoholic beverages, Virginia, like other alcohol beverage control states, has consistently tried to balance the conflicting requirements of the state and localities for revenues from taxes on alcoholic beverages with the need to keep the products priced at a competitive level to discourage bootlegging -- all without encouraging consumption.[5]

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[2]Chapters 3 and 4, *Acts of Assembly*, 1933.

[3]"Liquor Tax" 13 *Congressional Digest* 61 (1934). The states that ratified were Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Idaho, Illinois, Indiana, Iowa, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Nevada, New Hampshire, New Jersey, New Mexico, New York, Ohio, Oregon, Pennsylvania, Rhode Island, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, and Wyoming.

[4]"The Role Occupied by Repeal in the Drama of Economic Recovery Is Gradually Becoming Apparent As Remote Ramifications of Beer Industry Are Being Affected," 117 *Literary Digest* 10 (1933).

[5]*Report of the Commission to Study the Alcoholic Beverage Control System* (Senate Document No. 15, 1953).

Virginia's policy relating to the taxation of alcoholic beverages was best summarized in the 1933 Report of the Liquor Control Committee:

> *Temperance, social betterment, and respect for law should be the prime objectives of any system of liquor control. Taxes should be levied as a method of promoting social control and not primarily raising State or local revenues. The system should not have for its object the rehabilitation of the finances of any class of citizens, type of industry or locality.*[6]

Virginia's liquor control plan, enacted in 1934, provided a fairly low tax rate on alcoholic beverages to maintain the retail price as low as possible to discourage the illegal manufacture of alcoholic beverages. Originally, taxes on alcoholic beverages were limited to a state and local license tax that varied based on the type of license and included a state excise tax on beer. Virginia did not impose a state excise tax on wine or distilled spirits until 1980.[7] All tax revenues collected were deposited into the state's general fund, with a portion of net profits distributed to localities based on population. Additionally, a portion of the general fund revenues were to be used for operating expenses of the Alcoholic Beverage Control (ABC) Department.[8]

Tax increases on alcoholic beverages have been infrequent in the Commonwealth. In 1982, the state tax on distilled spirits was increased from 15 percent to 20 percent. In 1986 fees charged for licenses to sell alcoholic beverages were increased slightly. In 1988, the General Assembly transferred the administration and collection of the beer and beverage excise tax from the Tax Department to the ABC Department to centralize ABC tax collection procedures.

Current System of Taxing

The present alcoholic beverage control system is basically the same as that enacted in 1934, except for the adoption of the mixed beverage laws in 1968. The ABC Board's mission is to regulate and control the possession, sale, transportation, and delivery of alcoholic beverages into and within the Commonwealth. Raising revenues for the Commonwealth is a secondary goal of the Department, and this is consistent with the fact that ABC taxes comprise a mere 1.04 percent of the Commonwealth's general fund, compared to the sales tax and income tax, which combined comprise almost 75 percent of the general fund revenues.[9]

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[6] *Report of the Liquor Control Committee* (Senate Document No. 5, December, 1933).

[7] Chapter 624, *Acts of Assembly*, 1980.

[8] Chapter 94, *Acts of Assembly*, 1934.

[9] Department of Accounts *Summary Report on General Fund Revenue Collections for Fiscal Year 2000.*

The Department, which operates 250 retail stores across the Commonwealth, administers and collects four types of state taxes on alcoholic beverages:

1. Liter tax on wine (40 cents per liter sold);[10]
2. Distilled spirits tax (four percent of the sales price on wine from state vineyards sold through state stores and 20 percent of the sales price on distilled spirits);[11]
3. License tax (amount varies depending on type of license);[12] and
4. Beer and beverage excise tax ($7.95 per 31-gallon barrel; two cents per bottle of seven ounces or less; 2.65 cents per bottle of seven to 12 ounces; and 2.22 mills per ounce for bottles of more than 12 ounces).[13]

In fiscal year 2000, alcoholic beverage taxes generated $117,204,000 in revenues for the Commonwealth.[14]

In addition to taxing authority, the ABC Department can impose a reasonable markup on the sale price for alcoholic beverages.[15] The Department uses a variable mark-up based on size to encourage trade-up to more profitable items (i.e. mark-up decreases as size of the product increases). The average mark-up for all sizes is 52 percent. This mark-up covers the Department's costs of purchasing and transporting the beverages for sale at the state liquor stores. The total price charged in Virginia for distilled spirits is the delivered cost plus (i) one dollar per case handling charge, (ii) 52 percent mark-up, with bottle price rounded to the next highest nickel, (iii) 20 percent state tax rounded again to the next highest nickel, and (iv) 4.5 percent sales tax.

Disposition of ABC Tax Revenues and Net Profits

All revenues collected from the state tax (20 percent) on distilled spirits, the wine tax (four percent), the malt beverage tax, and sales tax are deposited into the Commonwealth's General Fund (see Table 1). In fiscal year 1999, revenues collected in these four categories totaled $122,924,277, an increase of 9.6 percent over fiscal year 1998.

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[10] Va. *Code* § 4.1-234 (2000). The wine liter tax was enacted in 1980 and combined the following previous taxes: the state wine tax, the state sales tax on wine, and the Department's markup on wine sold through distributors.

[11] *Id.*

[12] Va. *Code* § 4.1-231 (2000); local governments can impose local license tax under Va. *Code* § 4.1-233.

[13] Va. *Code* § 4.1-236 (2000); Chapter 261, *Acts of Assembly*, 1988, changed administration of the beer and beverage tax from the Tax Department to the ABC Department.

[14] Department of Accounts *Summary Report on General Fund Revenue Collections for Fiscal Year 2000.*

[15] Va. *Code* § 4.1-235 (2000).

TABLE 1
Alcoholic Beverage Control
Tax Revenue -- Fiscal Years 1990 - 1999

FY Year	State Taxes	Sales Tax	Malt Beverage Tax	Wine Tax	Total Taxes
1990	$49,715,028	0	$38,977,713	$12,912,874	$101,605,615
1991	50,796,844	0	39,052,964	12,739,522	102,589,330
1992	51,184,687	0	38,143,713	13,040,006	102,368,406
1993	50,022,888	$11,501,295	38,249,918	13,729,666	113,503,767
1994	48,587,776	11,093,714	38,785,490	14,248,436	112,715,416
1995	48,371,114	11,805,043	38,427,299	14,885,512	113,488,968
1996	48,414,294	10,957,647	38,455,833	16,460,868	114,288,642
1997	49,514,115	11,210,106	38,443,318	18,668,349	117,835,888
1998	50,616,001	11,414,286	39,224,993	16,836,976	118,092,256
1999	53,232,248	11,973,117	39,945,570	17,773,342	122,924,277

Source: Department of Alcoholic Beverage Control Annual Reports for FY 1990-1999.

The wine liter tax (40 cents per liter) is distributed according to the following formula: 44 percent is distributed to localities on the basis of general population, 44 percent to the general fund, and 12 percent to the Alcoholic Beverage Control Department for operating expenses. In fiscal year 1999, the total wine liter tax collections were $17,773,342, with localities and the general fund each receiving $7,820,270 and ABC retaining $2,132,801 for operating expenses.

In fiscal year 1999, the total net profits from ABC sales were $38,534,293, the largest in the past 10 years. By statute the net profits are distributed to the general fund of the state treasury and to localities on the basis of general population (see Table 2).

TABLE 2
Alcoholic Beverage Control
Distribution of Profits -- Fiscal Years 1990-1999

FY Year	Net Profit	To General Fund	To Localities
1990	$32,554,474	$19,780,933	$12,773,541
1991	38,124,627	22,189,513	17,484,617
1992	39,775,748	24,587,231	15,188,517
1993	37,736,493	20,526,843	17,209,650
1994	32,137,600	18,720,652	13,416,948
1995	32,203,683	18,724,851	13,478,832
1996	38,109,168	20,636,002	17,473,166
1997	35,149,392	20,123,695	15,025,697
1998	31,790,981	19,006,803	12,784,178
1999	38,534,293	21,986,578	16,547,715

Source: Department of Alcoholic Beverage Control Annual Reports for FY 1990-1999.

In fiscal year 1999, the general fund's portion of net profits was $21,986,578, and the local portion of net profits totaled $16,547,715. The revenues reflected in net profits include taxes collected from the state ABC licenses. Tables 3 and 4 summarize the ABC payments to specific cities and counties in fiscal year 1999.

TABLE 3
Summary of ABC Payments to Cities as of June 30, 1999

City	Total Profits FY 1999	Wine Tax FY 1999	City	Total Profits FY 1999	Wine Tax FY 1999
Alexandria	$297,261	$159,639	Manassas	$73,450	$39,445
Bedford	16,515	8,869	Manassas Park	18,004	9,669
Bristol	49,277	26,466	Martinsville	43,211	23,206
Buena Vista	17,127	9,197	Newport News	458,367	246,158
Charlottesville	108,215	58,115	Norfolk	698,489	375.112
Chesapeake	406,345	218,221	Norton	11,354	6,097
Clifton Forge	12,509	6,718	Petersburg	98,997	53,164
Colonial Heights	42,949	23,065	Poquoson	29,423	15,801
Covington	19,244	10,335	Portsmouth	277,818	149,197
Danville	141,852	76,179	Radford	42,617	22,887
Emporia	14,648	7,866	Richmond	542,209	291,184
Fairfax	53,189	28,564	Roanoke	258,030	138,571
Falls Church	26,458	13,672	Salem	63,624	34,168
Franklin	22,266	11,957	Staunton	65,400	35,121
Fredericksburg	50,871	27,319	Suffolk	139,411	74,868
Galax	17,910	9,618	Virginia Beach	1,050,980	564,411
Hampton	357,763	192,130	Waynesboro	49,593	26,633
Harrisonburg	82,099	44,090	Williamsburg	30,503	16,381
Hopewell	61,763	33,169	Winchester	58,678	31,512
Lexington	18,605	9,991			
Lynchburg	176,591	94,835	**ALL CITIES**	**$6,002,637**	**$3,223,618**

Source: Department of Alcoholic Beverage Control Annual Report for FY 1999.

TABLE 4
Summary of ABC Payments to Counties as of June 30, 1999

County	Total Profits FY 1999	Wine Tax	County	Total Profits FY 1999	Wine Tax
Accomack	$84,992	$45,644	King & Queen	$16,815	$9,030
Albemarle	182,319	97,911	King William	29,177	15,669
Alleghany	34,875	18,621	Lancaster	29,282	15,725
Amelia	23,493	12,617	Lee	65,494	35,172
Amherst	76,407	41,033	Loudoun	230,278	123,667
Appomattox	32,949	17,695	Louisa	54,342	29,183
Arlington	456,918	245,380	Lunenburg	30,530	16,396
Augusta	148,148	78,487	Madison	31,947	17,157
Bath	12,831	6,891	Mathews	22,320	11,986
Bedford	121,790	65,405	Mecklenburg	77,998	41,888
Bland	17,416	9,353	Middlesex	23,135	12,424
Botetourt	66,820	35,884	Montgomery	197,617	106,127
Brunswick	42,925	23,052	Nelson	34,164	18,347
Buchanan	83,773	44,989	New Kent	27,926	14,997
Buckingham	34,417	18,484	Northampton	34,691	18,630
Campbell	127,191	68,306	Northumberland	27,988	15,030
Caroline	51,379	27,592	Nottoway	40,086	21,527
Carroll	71,025	38,142	Orange	57,272	30,757
Charles City	16,796	9,020	Page	57,991	31,143
Charlotte	31,250	16,782	Patrick	46,717	25,088
Chesterfield	560,300	300,900	Pittsylvania	148,847	79,936
Clarke	32,354	17,375	Powhatan	40,982	22,008
Craig	11,689	6,277	Prince Edward	47,332	25,419
Culpeper	74,303	39,903	Prince George	73,242	39,333
Cumberland	19,828	10,648	Prince William	577,940	310,373
Dickenson	47,110	25,299	Pulaski	92,230	49,531
Dinwiddie	59,673	32,046	Rappahannock	17,705	9,508
Essex	23,231	12,476	Richmond	19,445	10,443
Fairfax	2,187,999	1,175,028	Roanoke	212,004	113,853
Fauquier	130,634	70,158	Rockbridge	49,061	26,348
Floyd	31,990	17,180	Rockingham	153,724	82,555
Fluvanna	33,179	17,819	Russell	76,164	40,903
Franklin	105,739	56,785	Scott	62,039	33,317
Frederick	122,247	65,651	Shenandoah	84,583	45,424
Giles	43,757	23,499	Smyth	87,233	46,847
Gloucester	80,560	43,263	Southampton	45,682	24,533
Goochland	37,867	20,336	Spotsylvania	153,475	82,421
Grayson	43,522	23,373	Stafford	163,723	87,925
Greene	27,530	14,785	Surry	16,430	8,823
Greensville	21,945	11,785	Sussex	28,528	15,320
Halifax	96,331	51,733	Tazewell	122,881	65,991
Hanover	169,258	90,897	Warren	69,894	37,536
Henrico	582,451	312,795	Washington	121,985	65,507
Henry	152,243	81,759	Westmoreland	41,388	22,227
Highland	7,045	3,783	Wise	106,285	57,079
Isle of Wight	66,983	35,972	Wythe	68,100	36,572
James City	93,497	50,211	York	113,453	60,928
King George	36,166	19,423			
			ALL COUNTIES	**$10,545,069**	**$5,663,050**

Source: Department of Alcoholic Beverage Control Annual Report for FY 1999

In addition to the preceding revenue distributions, the Department of Alcoholic Beverage Control has been required for numerous years by the appropriations act to reimburse the general fund of the state treasury from net profits for expenses incurred for care, treatment, study, and rehabilitation of alcoholics by the Department of Mental Health, Mental Retardation, and Substance Abuse Services. The amount of the reimbursement is established by the General Assembly in the appropriations act; and it therefore varies annually. In fiscal year 1999, $11,587,535 of net profits were transferred by the ABC Department for this purpose.[16]

Comparison with Other States

Eighteen states including Virginia have established state alcoholic beverage control agencies to administer sales of alcoholic beverages. Table 5 summarizes the tax rates imposed on alcoholic beverages in these 17 other states. State tax rates and markups on alcoholic beverages vary widely, and these factors affect the total revenues generated from ABC sales.

In comparison to other control states, between 1997 and 1998, Virginia has decreased slightly in the volume of distilled spirits sold, but increased in the volume of wine and beer sold, according to the Adams Business Media *1999 Fact Book, Alcohol Beverage State Facts and Regulations.* Among other control states, Virginia ranked sixth in volume of distilled spirits with a 0.5 percent decrease in volume of sales between 1997 and 1998. Wine sales increased by 3.8 percent in the same period with Virginia ranking fifth among other control states. Virginia also ranks fifth in volume of beer sales with an increase of 6.8 percent during this same period.

TABLE 5
State Alcoholic Beverage Excise Tax Rates
And/Or Markup in Control States as of 1999

	Alabama
BEER:	$.53 excise tax per gallon plus markup
WINE:	$1.70 excise tax per gallon, plus markup
SPIRITS:	56% state tax; 30% markup
OTHER TAXES:	6% sales tax
	Idaho
BEER:	$.15 excise tax per gallon
WINE:	$.45 excise tax per gallon
SPIRITS:	48% to 82% mark up on spirits, includes 5% sales tax
OTHER TAXES:	5% sales tax
	Iowa
BEER:	$.19 excise tax per gallon
WINE:	$1.75 excise tax per gallon
SPIRITS:	50% mark-up over state's laid-in cost
OTHER TAXES:	5% retail sales tax

[16] Virginia Department of Alcoholic Beverage Control Annual Report 1999.

TABLE 5
(CONTINUED)

Maine	
BEER:	$.25 excise tax per gallon plus $.10 premium tax per gallon
WINE:	$.84 per gallon still wine and $1.24 tax for sparkling wine
SPIRITS:	Mark-up varies by class of distilled spirits plus $1.25 premium tax per gallon
OTHER TAXES:	NONE
Michigan	
BEER:	$.20 excise per gallon
WINE:	Between $.51 to $.76 excise tax per gallon
SPIRITS:	A series of 4 taxes totaling 13.85%
OTHER TAXES:	6% consumer sales tax
Mississippi	
BEER:	$.43 excise tax per gallon
WINE:	27.5% markup plus $1 gallon tax on sparkling wine or $.35 tax/gallon table wine
SPIRITS:	27.5% total markup plus $2.50 excise tax per gallon
OTHER TAXES:	NONE
Montana	
BEER:	$.10 excise tax per gallon
WINE:	$1.02 excise tax per gallon
SPIRITS:	40% markup plus 26% state tax, price rounded up to nearest 5 cents
OTHER TAXES:	NONE
New Hampshire	
BEER:	$.30 excise tax per gallon
WINE:	Various mark-ups based on type of wine
SPIRITS:	Various mark-ups based on type of liquor
OTHER TAXES:	NONE
North Carolina	
BEER:	$.53 excise tax per gallon
WINE:	$.79 excise tax per gallon
SPIRITS:	28% excise tax plus costs
OTHER TAXES:	6% consumer sales tax
Ohio	
BEER:	$.18 excise tax per gallon
WINE:	Prevailing cost determined then 33.3% mark-up on wholesale and 50% mark-up on retail price
SPIRITS:	30% mark-up and $3.38 excise tax per gallon
OTHER TAXES:	NONE
Oregon	
BEER:	$.08 excise tax per gallon
WINE:	$.67 to $.77 per gallon
SPIRITS:	104% markup
OTHER TAXES:	NONE
Pennsylvania	
BEER:	Mark-up plus $.08 excise tax per gallon
WINE:	Mark-up plus 18% excise tax per gallon
SPIRITS:	Mark-up plus 18% excise tax per gallon
OTHER TAXES:	NONE
Utah	
BEER:	$.35 excise tax per gallon
WINE:	All products more than 3.2% alcohol are taxes 61% mark-up plus 13% school lunch tax plus 6.25% sales tax
SPIRITS:	Same as wine
OTHER TAXES:	NONE
Vermont	
BEER:	$.27 excise tax per gallon up to 6%; $.55 tax per gallon over 6% to 8%
WINE:	$.55 excise tax per gallon
SPIRITS:	Mark-up plus 25%
OTHER TAXES:	NONE

TABLE 5
(CONTINUED)

Washington	
BEER:	$.26 excise tax per gallon
WINE:	$.87 tax/gallon with less than 14% alcohol; $1.72 tax/gallon with more than 14% alcohol
SPIRITS:	20.5% sales tax plus $9.24 excise tax per gallon
OTHER TAXES:	NONE
West Virginia	
BEER:	$.18 excise tax per gallon
WINE:	$.98 excise tax per gallon
SPIRITS:	25% mark- plus $1.05/case handling and storage feep
OTHER TAXES:	6% sales tax for beer, 11% sales tax for wine and spirits
Wyoming	
BEER:	$.02 excise tax per gallon
WINE:	$.28 excise tax per gallon
SPIRITS:	$.95 excise tax per gallon
OTHER TAXES:	NONE

Source: *Adams Fact Book, Alcohol Beverage State Facts and Regulations* (Adams Business Media, 1999)

Issues

Privatization

During the 1989 Session of the General Assembly, legislation was introduced to eliminate state-operated liquor stores and allow privately operated retail stores to sell distilled spirits in the Commonwealth. Although this bill was passed by indefinitely, the issue was studied by a subcommittee of the House General Laws Committee. The subcommittee report to the 1990 General Assembly recommended against privatization of the sale of distilled spirits at that time.

In 1993, a joint subcommittee began investigating privatization of several state-controlled functions, including the sale of distilled spirits. However, the final report of this subcommittee was silent with respect to the sale of distilled spirits.

Efficiency and Expansion

During the past several years ABC has worked to plan and implement computer-based technologies designed to improve overall Department operational efficiency. In August 1998, the new Product Distribution System (PDS) was implemented. This real-time, on-line system provides access to information about inventory levels and current and historical sales. Hand-held bar code scanners are used to automate warehouse activities. The System forecasts store orders and sets them for preliminary review by the store manager. The PDS System also directs staging of the transportation of orders to the stores.

In 1999, the Department made a concerted effort to open new store locations. Stores were opened in Rosslyn, Stafford County, Virginia Beach (2), Loudoun County, Henrico County, and Prince William County. Sales in FY 2000 topped the $350 million mark. In the coming year, the Department is evaluating additional locations along with e-commerce opportunities.

Summary

Alcoholic beverage taxes are unique to the Commonwealth's tax structure because, unlike most other taxes, they are not levied for the primary purpose of producing revenues. Instead, alcoholic beverage taxes are merely one component of the Commonwealth's overall alcoholic beverage control policy, which has the three goals of service, control, and revenues. ABC profits exceeded $38 million in 1999, constituting a little more than one percent of the Commonwealth's general fund.

Local governments receive a large portion of ABC profits and 44 percent of the wine liter tax revenues, making them heavily dependent upon ABC revenues to meet their budget demands. In fiscal year 1999, localities received more than $24 million from alcoholic beverage revenues collected by the Commonwealth.

Periodically the General Assembly has considered the issue of privatizing the sale of distilled spirits in the Commonwealth. However, to date, sufficient support for such measures has been lacking.

Recordation Taxes

History

Tax Base

Issues

Summary

Recordation Taxes

History

A tax on deeds involving real estate was first enacted on March 28, 1843, and was imposed at the rate of 50 cents per deed. Thereafter the tax was increased to one dollar per deed and then to one dollar for the first $1,000 of consideration and 10 cents for every $100 of consideration in excess of $1,000. The state recordation tax assumed its present form in this century and except for numerous exemptions from the tax passed by the General Assembly, the recordation tax has remained relatively unchanged. The recordation tax law changes may be summarized as follows:

1922 10 cents per $100 of consideration or actual value.

1926 12 cents per $100 of consideration or actual value.

1948 15 cents per $100 of consideration or actual value.[1]

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[1] The state recordation tax remains at this level today. See Va. Code §§ 58.1-801 and 58.1-803.

1958 Local option tax equal to one-third of the state tax.

1966 Recordation taxes no longer apply to documents relating to personal property because the Uniform Commercial Code superseded the recordation system for almost all property except real estate.

1968 Additional tax imposed at rate of 50 cents per $500 (also known as the grantor's tax), followed language of the federal stamp tax, which was repealed effective January 1, 1968. The local option tax authorization was not extended to this "additional" (grantor's) tax.

1984 Recodification of Title 58 as Title 58.1 placed the exemptions from tax in two sections.

1989 Chapter 286, *Acts of Assembly, 1989*, provided for annual distributions of $40 million to the U.S. Route 58 Corridor Development Fund, effective January 1, 1990. Chapter 713, *Acts of Assembly, 1989*, provided for annual distributions of $40 million to counties and cities based on point of origin, effective July 1, 1990, with a June 30, 1995, expiration date. Both distributions were subject to future appropriation by the General Assembly and neither action was fully funded by the 1990 Session of the General Assembly. The 1990 Session delayed funding the Chapter 713 distribution and funded the Chapter 286 distribution only to the extent necessary to fund debt service on bonds issued to build the first part of the U.S. Route 58 Corridor Development Program. Subsequent annual debt service requirements have been funded, as necessary, by the General Assembly from the general fund.

1992 The General Assembly funded one-half ($20 million) of the Chapter 713 distribution, effective for the second year of the biennium. See Item 274 of § 1-77 of Chapter 893, *Acts of Assembly, 1992*, at page 1820 -- the Appropriations Act.

1993 Chapter 391, *Acts of Assembly, 1993*, created the Northern Virginia Transportation District Fund and the Transportation Improvement Program Set-aside Fund and funded the former with $9.5 million in recordation taxes attributable to the cities of Alexandria, Fairfax, Falls Church, Manassas, and Manassas Park and the counties of Arlington, Fairfax, Loudoun, and Prince William. See Item 274 of § 1-77 of Chapter 994, *Acts of Assembly, 1993*, at page 1818. The Set-aside Fund received no distribution. The 1993 legislation also eliminated the five-year sunset provision on annual distributions of $40 million to localities and made the program permanent.

1994 Chapter 597, *Acts of Assembly, 1994*, provides for an additional $19 million from recordation taxes to the Northern Virginia Transportation District Fund.

2000 Funds from state recordation taxes distributed as follows: $17 million to the Northern Virginia Transportation District Fund; $2.3 million to the Transportation Improvement Program Set-aside Fund to be used by the City of Chesapeake to pay the debt service on transportation bonds issued by the city; $40 million to the U.S. Route 58 Corridor Development Fund; and $40 million to local governments.

From 1984 through 2000, the revenue derived from the state recordation tax has almost tripled, with tremendous fluctuations being experienced for various fiscal years depending upon changes in the economy, interest rates, and tax policy (matters inherently interrelated). Because the tax is based on the sales price of real estate, it is extremely sensitive to fluctuations in the economy, particularly the real estate market. Moreover, two additional factors are at work: (i) the state of the economy (which affects the number of new housing units being built) and (ii) the effects of inflation in general. The volatility of the state recordation tax is amply demonstrated by the revenue generated by the tax during the past 10 fiscal years, as shown in Table 1.

TABLE 1
State Recordation Taxes, Fiscal Years 1984, 1990-2000

Fiscal Year Ending June 30	Amount	% Variation From Previous Year
1984	$ 54,622,000	-
1990	$ 91,648,000	-
1991	$ 71,861,000	- 21.6
1992	$ 83,657,000	+16.4
1993	$ 99,581,000	+19.0
1994	$ 114,926,000	+15.4
1995	$ 84,707,000	-26.3
1996	$ 95,479,000	+12.7
1997	$ 103,441,000	+ 8.3
1998	$ 126,816,000	+22.6
1999	$ 157,872,000	+24.5
2000	$ 146,288,000	- 7.3

SOURCE: *Department of Accounts Summary Report on General Fund and Lottery Revenue Collections*.

The 1992 and 1993 figures demonstrate that Virginia's economy had fully recovered from the recession in the early 1990s. Between 1990 and 1991, recordation tax revenues fell nearly $20 million in the midst of the recession. However, by the end of fiscal year 1993, the Commonwealth had, for the most part, recovered from the recession as recordation tax revenues for that year eclipsed fiscal year 1990 recordation tax revenues.

The nearly $23.4 million increase (or 22.6 percent) in recordation tax revenues between 1997 and 1998 and the $31.1 million increase (or 24.5 percent) in recordation tax revenues between 1998 and 1999 were the result of a thriving economy with incredibly low interest rates and inflation. In fact, the increase in collections in 1998 and 1999 was skewed by the surge in refinancing old debt. Thus, it is difficult to estimate with any certainty the increase in recordation tax revenues attributable to the purchase of real estate.

In summary, Table 1 demonstrates the volatility of the recordation tax as a revenue source. Despite the possibility of such dramatic fluctuations, the Commonwealth Transportation Board, as of the summer of 1999, had sold almost $601 million in debt for the U.S. Route 58 Corridor Development Program and more than $307 million in debt for the Northern Virginia Transportation District Program, secured in part by a portion of recordation tax collections. A number of these bonds have terms of 25 years or more. Relying on recordation tax collections to pay debt service reduces the amount left in the general fund to fund other state programs.

The Department of Accounts Summary Report for 2000 shows recordation tax collections as approximately 1.3 percent of the Commonwealth's total general fund of $11.1 billion.

Tax Base

Virginia's recordation taxes are made up of two components: the state recordation tax under §§ 58.1-801 and 58.1-803 imposed at a rate of 15 cents per $100, and the grantor's or additional tax under § 58.1-802 imposed at a rate of 50 cents per $500. The state recordation tax is imposed on the privilege of recording any deed, lease, contract, or mortgage relating to real estate and certain railroad rolling stock. On deeds of bargain and sale, the tax is imposed on the consideration of the deed (the sales price) **or** the actual value of the property conveyed, whichever is greater.[2] This option is placed in the statute as a safeguard to ensure that the consideration is not understated as a tax avoidance measure. On deeds of trust and mortgages, the tax is imposed on the amount of debt, bonds, or obligation secured by the debt instrument.[3] Special rules apply for construction loans, supplemental deeds of trust, and deeds of release, confirmation, correction, partition or incidental to a separation or divorce.

If a contract or memorandum of contract relating to real estate is recorded, with the exception of a lease for a term of years, the tax is imposed on the consideration or value contracted for. If a lease for a term of years is involved, however, the tax is based on the consideration or value contracted for unless the lease term multiplied by the annual rental exceeds the fair market value of the property, in which case the tax is imposed on

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2 Va. Code § 58.1-801.

3 Va. Code § 58.1-803.

the fair market value of the property.[4] Special rules apply for the recording of leases of oil and gas rights and leases of coal and other mineral rights.

Localities are authorized to impose a local recordation tax in an amount equal to one-third of the amount of the state recordation tax.[5] Almost all Virginia cities and counties have exercised this authority and enacted a local recordation tax.

The grantor's or additional tax, the other component of Virginia's recordation taxes, is imposed on the consideration or value of the interest purchased, exclusive of the amount of liens. This tax does not apply to instruments securing a debt and is customarily paid by the seller.[6] However, by contract or price manipulation, the economic incidence of the tax may be passed on to the buyer. Localities are not authorized to "piggy-back" onto the grantor's tax; however, subsection B of § 58.1-802 of the Code of Virginia provides that the local circuit court clerk (the tax assessing and collecting official) shall remit one-half of the grantor's tax to the state treasury and the other half to the locality or localities where the property conveyed is located.

Exemptions from the state recordation tax (the tax imposed by §§ 58.1-801 and 58.1-803) are as follows:

1. Certain deeds to incorporated nonprofit institutions of learning;
2. Certain deeds to the trustees of a church or religious body;
3. Deeds to the United States, the Commonwealth, and political subdivisions of the Commonwealth;
4. Deeds to the Virginia Division of the United Daughters of the Confederacy;
5. Certain deeds to nonprofit hospitals or affiliated nonprofit corporations;
6. Deeds to a corporation pursuant to § 351 of the Internal Revenue Code;
7. Deeds from a corporation to its stockholders in a liquidation qualifying for favorable tax treatment under the Internal Revenue Code;
8. Deeds to a partnership, limited liability company, or corporation upon a merger or consolidation or under a transaction qualifying for favorable tax treatment under the reorganization provisions of the Internal Revenue Code;
9. Deeds between parent and subsidiary corporations qualifying for favorable tax treatment under the Internal Revenue Code;
10. Certain deeds involving transfers between a partnership and its partners or between a limited liability company and its members;
11. Certain deeds involving trusts and estates and their beneficiaries;

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[4] Va. Code § 58.1-807.

[5] Va. Code § 58.1-3800.

[6] Va. Code § 58.1-802.

12. Certain deeds from a nonprofit organization organized to erect or rehabilitate low-cost homes that are sold at cost to persons who otherwise would be unable to afford to buy a home through conventional means;
13. Certain construction loan deeds of trust involving incorporated nonprofit institutions of learning, churches or religious bodies, and nonprofit hospitals, and deeds of trust given by a local government to secure a debt to another local government; and
14. Certain construction loan deeds of trust involving the securing of a loan by an organization described in item 12.[7]

Exemptions from the grantor's tax (the tax imposed by § 58.1-802) are as follows:

1. Transactions listed in items 6 through 11 above;
2. Instruments given to secure a debt;
3. Deeds from an incorporated nonprofit institution of learning;
4. Certain deeds to the Commonwealth and its political subdivisions; and
5. Deeds from churches or religious bodies.[8]

In addition, certain deeds of gift, leases to the United States, the Commonwealth and its political subdivisions, and deeds and leases involving The Nature Conservancy are exempt from all state and local recordation taxes, including the grantor's tax.[9]

Recordation taxes are assessed and collected at the time of recordation by the circuit court clerk. Payment of the tax is a prerequisite for recordation.[10] However, because there are more than 100 circuit court clerks of court and numerous personnel under them, uniform administration of the tax is difficult. As the real estate community develops new kinds of transactions and instruments, the tax may be subject to varying interpretations. There is no formal mechanism for central control or interpretation, and the Reports of the Attorney General contain many opinions in this area over the years. Ultimately, the Department of Taxation is empowered to seek collection or make refunds of these taxes.

Virginia's state and local tax burden on real estate transfers compares favorably with that of other states (See Table 2). Table 2 reveals that Virginia's state recordation tax is one of the lowest in neighboring and surrounding states. Only Alabama and Georgia have a lower rate, at 50 cents per $500 of consideration. In addition, the total of all fees and state and local recordation taxes rarely exceeds one-half of one percent of the value of real estate in a typical transaction, including financing (i.e., deed and deed of trust recordation).

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7 Va. Code § 58.1-811.

8 *Id*.

9 *Id*.

10 Va. Code § 58.1-812.

According to a recent survey of state recordation and transfer taxes (local taxes are not included in the rankings)[11]:

- 14 states do not impose a tax on the transfer of real estate.
- Eight states have rates that are lower than Virginia's rates.
- One state has the same rate.
- 27 states and the District of Columbia have higher rates.

TABLE 2
Surrounding States' Real Estate Transfer Taxes
(Per $500 of Consideration)

State	Rate
Alabama	$ 0.50
Georgia	$ 0.50
Virginia	$ 0.75 (or 15 cents per $100)
North Carolina	$ 1.00
West Virginia	$ 1.10
South Carolina	$ 1.30
Tennessee	$ 1.85
Maryland*****	$ 2.50
District of Columbia	$11.00

*****State transfer tax rate only.
SOURCE: *Tax Rates and Tax Burdens in the District of Columbia: A Nationwide Comparison.*

Issues

With the recodification of Title 58 into Title 58.1, recordation taxes have been made less confusing. However, because these taxes are administered and collected locally, variations in interpretation are bound to occur. The question then is whether central control of what is ultimately a local act (the recordation of an instrument involving real estate) is necessary, and if necessary, whether central administration can be accomplished in a practical or feasible manner. Except for the Auditor of Public Accounts' review, no examination of uniformity, or the lack thereof, is made, and there can be no assurance that exemptions are being uniformly applied, or that the consideration for transactions is being accurately reported, jurisdiction by jurisdiction, or for that matter, transaction by transaction in the same jurisdiction. In addition, the recordation taxes are likely to continue to provoke discussion because of the possible distribution of $40 million annually of recordation taxes back to the localities, as well as the U.S. Route 58 Corridor Development Program, and the use of such "revenue sharing" distribution as security for debt.

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11 *Tax Rates and Tax Burdens in the District of Columbia: A Nationwide Comparison.*

Summary

As is illustrated in this section, there can be dramatic fluctuations in the annual amount of recordation taxes collected. This is fueled by factors beyond the control of the General Assembly -- the health of the national economy, interest rates, and inflation. Thus, over the short-term, recordation tax revenues can experience significant fluctuations from year to year.

However, at its core, recordation taxes rest on transactions in real estate. Because real estate is a scarce resource and is almost universally desired, generally there will always be a strong demand for this resource. This is even truer in Virginia as the growth in the Commonwealth's population pushes up the demand for ownership of real property. As a result, while short-term fluctuations in recordation tax revenues are not unnatural, over the long-term, revenues from recordation taxes can be expected to continue to grow. Finally, to the extent that the tax is "earmarked" for redistribution to the localities, or as a funding source to support debt service for transportation bond issues, most of this revenue source is spent before it is collected.

Estate and Gift Tax

History

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Estate and Gift Tax

History[1]

Virginia Inheritance Tax

Virginia enacted its first death tax in 1844, when an inheritance tax was imposed on collateral heirs at a rate of two percent "on every hundred dollars of the clear value of such estate" received. Collateral heirs did not include grandparents, parents, siblings, spouses, children, or other lineal descendants. In 1870 the inheritance tax on collateral heirs was raised to six percent, where it remained until 1903, when the tax rate was reduced to five percent. In 1916 the inheritance tax was extended to grandparents, parents, siblings, spouses, children, and other lineal descendants at a rate of one percent; however, the tax rate on collateral inheritances was left at five percent, thereby creating two classes of beneficiaries.

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[1]Substantial portions of the material under this heading were liberally extracted from House Document 18, *Report of the House Finance Committee on Inheritance and Gift Tax Laws* (1978).

In 1916 the federal government enacted a death tax on a decedent's privilege of transferring property, or an estate tax. The federal statute provided for a state death tax credit against the federal liability based on a specified formula, to the extent that state death taxes were actually paid. In 1926 Virginia adopted legislation to take advantage of the state death tax credit allowed under the federal estate tax law. This enactment occurred because, under certain circumstances, the state death tax credit allowed could exceed Virginia's inheritance tax, and if the state death tax credit amount was not actually paid to Virginia, the difference between the amount actually paid and the allowed state death tax credit would simply be paid to the federal government. By enacting this so-called "pick-up" statute, Virginia could increase its inheritance tax revenues without increasing an estate's total federal-state death tax liability. The pick-up tax applied only in those cases where the state death tax credit exceeded Virginia's inheritance tax; in all other cases, Virginia's inheritance tax applied. Therefore, in every case where the credit for state death taxes paid, computed under the federal estate tax law, exceeded the total tax otherwise payable under Virginia's "regular" inheritance tax, Virginia practiced "absolute" conformity with federal law provisions.

In 1934, three classes of beneficiaries were created in the Virginia inheritance tax structure, and the tax levied depended on the share of the net estate (gross estate minus deductions and exemptions) received by the beneficiary and on the class of the beneficiary. Class A beneficiaries included spouses, parents, grandparents, children, grandchildren, and all other lineally related persons. The first $5,000 of the inheritance received by each beneficiary was exempt and the tax rate imposed ranged from one percent to five percent, depending upon the amount inherited. Class B beneficiaries were siblings or nieces and nephews of whole or half blood. This class had the first $2,000 of the inheritance received exempt and the applicable tax rate ranged from two percent to 10 percent. Class C beneficiaries were all others, and they received a $1,000 exemption before a tax rate of five percent to 15 percent was applied to their inheritance.

In conjunction with the above tax rates and exemptions, Virginia continued to impose a minimum tax equal to the federal estate tax credit, under the "pick-up" statute, if that credit exceeded the Virginia inheritance tax. Due to the vast difference between maximum state versus federal tax rates (i.e., five percent, 10 percent or 15 percent, as compared to the 70 percent maximum federal rate), Virginia automatically conformed to federal estate law whenever substantial estates were involved ($550,000 or more left outright to one child, or $1,100,000 or more left outright to a spouse). This taxing structure, including rates and exemptions, remained essentially unchanged from 1934 to 1978, when the Virginia Estate Tax, effective January 1, 1980, was enacted.

That there was a distinction between a death tax on the decedent's estate (an estate tax) and a tax on a beneficiary's inheritance (an inheritance tax) may have seemed academic in terms of the economic net burden of the tax. However, Virginia's inheritance tax was significantly different from an estate tax from the standpoint of both revenues and administration. For example, an estate tax law makes no direct distinction when applying its rates to a beneficiary's inheritance (with the exception of such items as the charitable and marital deductions), unlike the classification scheme for beneficiaries available under an inheritance tax. More significantly, as a tax on the beneficiary's receipt of property, Virginia's tax allowed the imposition and collection of the tax to be delayed through the use of a trust or other means of conveying a future interest to a beneficiary. Imposition of the inheritance tax was deferred until the future beneficiary or remainderman (often undetermined at the date of death) actually received his interest. Therefore, assessment of the inheritance tax was deferred until all future interests came into actual possession (unless a settlement of future interests had been negotiated with the Department of Taxation).

Virginia Gift Tax

Congress first enacted a gift tax in 1924 to complement the estate tax. The gift tax was initially intended to deter lifetime gifts as a means of avoiding the estate tax. Virginia enacted its gift tax in 1934, essentially tracking the inheritance tax provisions in terms of classes of beneficiaries and tax rates; however, the value of both the gift property and gift taxes paid was removed from the cumulative rate structure of the Virginia inheritance tax.

The Virginia gift tax applied to the beneficiary shares of all real and personal property within the Commonwealth's jurisdiction transferred by gift in any one calendar year. The tax imposed was based on the value of the net taxable gift (actual value of gift less exemptions) received by each beneficiary. The gift tax was paid by the donor on the first day of May following the end of the calendar year in which the gift was given. As with the inheritance tax, the Virginia gift tax remained basically unchanged from its date of enactment in 1934 until its repeal in 1978, effective January 1, 1980.

1980 Virginia Estate Tax[2]

After the adoption by Congress of the Tax Reform Act of 1976, the momentum to make major revisions in Virginia's inheritance and gift tax laws continued to increase with the adoption of House Joint Resolution No. 34, in the 1977 Session of the General Assembly, to study such laws in light of the recent developments at the federal level. The subcommittee, among other things, found the following:

1. Virginia's inheritance and gift taxes were unreasonably burdensome to Virginia's taxpayers, particularly in terms of the revenues derived from these taxes.

2. The exemptions granted were unrealistically low (the $5,000 exemption for Class A beneficiaries did not provide the same exemption in real terms as it provided in 1934).

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[2]The Virginia Estate Tax must be distinguished from the Virginia tax on wills and administrations, or the probate tax, which is imposed at the rate of 10 cents per $100 value of the estate. The probate tax produces a minimal amount of tax revenue.

3. Because of Virginia's low exemption and rate structure, beneficiaries in the exempt and lowest taxable level of each of the three classes (i.e., less than $50,000 for class A and less than $25,000 for Classes B and C) filed 84.7 percent of the total returns while yielding only 13.0 percent of total revenue, exclusive of the "pick-up" returns.

4. The smallest estates were placed in the burdensome position of having to spend money for legal and administrative expenses associated with filing a proper state inheritance tax return, despite minimal tax liabilities.

5. Virginia's automatic lien for death taxes increased the post-death costs of transferring real estate because a certificate that inheritance taxes had been paid was required for filing in the chain of title.

6. Virginia's tax treatment of life insurance proceeds and future interests could provide anomalous results when compared to federal tax law treatment.

In addition, the Virginia Department of Taxation characterized the Commonwealth's inheritance and gift tax structure as "the department's most intricate and technical taxes." Due to the complexity of the system, which included three different classes of beneficiaries and three different rate schedules and exemption limits, the prevalent use of trusts and other forms of future interest transfers, and the small inheritances affected, it became clear that the administrative burden outweighed the benefits of such a system.

Accordingly, the subcommittee recommended that Virginia's inheritance and gift tax be repealed and that Virginia continue to impose the pick-up tax. This recommendation was made even though it would result in an estimated revenue loss to the Commonwealth of $24.6 million for the 1980-82 biennium. The adoption of a pick-up only tax would remove 25,000 estates from the filing requirements, leaving an estimated 710 returns to be filed in 1981. It was the subcommittee's view that this tax "relief" would benefit recipients of small and moderate inheritances and bring greater equity to Virginia's death tax laws. Those estates subject to the pick-up tax would simply file a copy of the federal estate tax return with a computation of the Virginia tax liability, and Virginia, by conforming to federal estate tax law, could save the Department of Taxation a portion of its $250,000 annual cost of administration.

The General Assembly adopted the recommendations of the subcommittee and enacted Chapter 838 of the 1978 *Acts of Assembly*. Subsequent amendments to the act replaced the state's automatic lien for estate taxes with a lien-filing procedure and added recapture tax and generation-skipping transfer tax sections. The recapture and generation-skipping transfer taxes are pick-up taxes that have been enacted to take advantage of state credit provisions found in the Internal Revenue Code. If no state tax were paid on these taxable events, the credit would not be available and the amount of the credit would be paid to the federal government.

Aside from the three amendments mentioned above and the recodification of Title 58, the Virginia estate tax has been basically unchanged since the date of its enactment. The Virginia estate tax revenues during the past 10 fiscal years are shown in Table 1.

TABLE 1

State Estate Tax, Fiscal Years 1991-2000*

Fiscal Year Ending June 30	Tax Collections	% Increase/Decrease from Previous Year
1991	$46,883,000	-25.7
1992	$48,791,000	+4.1
1993	$47,895,000	-1.9
1994	$82,996,000	+73.3
1995	$77,676,000	-6.4
1996	$69,398,000	-10.7
1997	$92,163,000	+32.8
1998	$122,304,000	+32.7
1999	$154,079,000	+26.0
2000	$150,100,000	-2.6

*The Virginia Estate Tax became effective January 1, 1980; however, collections of the inheritance tax continued through 1993. For purposes of this tabulation, all of these collections are combined.

SOURCE: Virginia Department of Accounts, *Summary Report on General Fund Revenue Collections.*

Tax Base

Virginia strictly conforms to federal estate tax law, except in the definition of the "federal credit" for state death taxes paid, that becomes the amount of the Virginia estate tax, or the so-called pick-up tax. Pursuant to § 58.1-901 Virginia's definition of this pick-up tax constitutes "modified" federal conformity because it sets the amount at the **greater** of the federal credit under federal law (1) as it existed in 1978 or (2) as it exists at the time of the decedent's death. In other respects Virginia conforms to federal estate tax law as such law exists at the time of the decedent's death. Thus, for example, as federal law exempts estates of $675,000 or less from federal estate taxes, via a $220,550 "unified" tax credit,[3] such estates are automatically exempt from the Virginia estate tax.

However, the benefit of the unified credit at the federal level was phased out as of January 1, 1993, for taxable estates that exceed $10,000,000. The federal unified gift and estate tax rates are found in Section 2001 (c) of the Internal Revenue Code, as summarized in Table 2.

[3]The unified tax credit is computed from a unified rate schedule under which lifetime taxable gifts and transfers at death are taxed on a cumulative basis. By 2002, estates of $1 million or less will be exempt from federal estate taxes; and by 2009 estates of $3.5 million or less will be exempt.

TABLE 2
Unified Gift and Estate Tax Rates

If the amount with respect to which the tentative tax to be computed is:	The tentative tax is:
Not over $10,000	18 percent of such amount.
Over $10,000 but not over $20,000	$1,800, plus 20 percent of the excess of such amount over $10,000.
Over $20,000 but not over $40,000	$3,800, plus 22 percent of the excess of such amount over $20,000.
Over $40,000 but not over $60,000	$8,200, plus 24 percent of the excess of such amount over $40,000.
Over $60,000 but not over $80,000	$13,000, plus 26 percent of the excess of such amount over $60,000.
Over $80,000 but not over $100,000	$18,200, plus 28 percent of the excess of such amount over $80,000.
Over $100,000 but not over $150,000	$23,800, plus 30 percent of the excess of such amount over $100,000.
Over $150,000 but not over $250,000	$38,800, plus 32 percent of the excess of such amount over $150,000.
Over $250,000 but not over $500,000	$70,800, plus 34 percent of the excess of such amount over $250,000.
Over $500,000 but not over $750,000	$155,800, plus 37 percent of the excess of such amount over $500,000.
Over $750,000 but not over $1,000,000	$248,300, plus 39 percent of the excess of such amount over $750,000.
Over $1,000,000 but not over $1,250,000	$345,800, plus 41 percent of the excess of such amount over $1,000,000.
Over $1,250,000 but not over $1,500,000	$448,300, plus 43 percent of the excess of such amount over $1,250,000.
Over $1,500,000 but not over $2,000,000	$555,800, plus 45 percent of the excess of such amount over $1,500,000.
Over $2,000,000 but not over $2,500,000	$780,800, plus 49 percent of the excess of such amount over $2,000,000.
Over $2,500,000 but not over $3,000,000	$1,025,800, plus 53 percent of the excess over $2,500,000.
Over $3,000,000	$1,290,800, plus 55 percent of the excess over $3,000,000.

With an unlimited marital deduction available at the federal level, transfers between spouses, whether by lifetime gift or at death, are entirely exempt from estate tax. Such an arrangement provides the maximum tax benefit to the beneficiary most favored under Virginia's old inheritance tax law. Virginia's conformity to federal estate tax laws also provides the following exemptions and deductions:

1. Proceeds from life insurance policies, to the extent the proceeds are not paid to the estate and so long as the decedent did not maintain the "incidents of ownership;"

2. Certain joint interests between spouses;

3. Casualty losses and theft losses not reimbursed by insurance; and

4. Charitable bequests.

Comparison with Other States

A comparison with other states shows that Virginia is in the majority by imposing only a "pick-up" tax. Thirty-seven other states and the District of Columbia impose a "pick-up" tax only; two states impose an estate and "pick-up" tax; while ten states impose an inheritance and "pick-up" tax. Table 3 provides a comparison of Virginia's tax with those of surrounding states.

TABLE 3
Surrounding States' Inheritance Taxes

States	Inheritance Tax	"Pick-Up" Tax
Georgia		X
Kentucky	X	X
Maryland	X	X
North Carolina		X
South Carolina		X
Tennessee	X	X
Virginia		**X**
West Virginia		X

Issue

New Federal Law

On June 7, 2001, President Bush signed into law the Economic Growth and Tax Relief Act of 2001 ("Act") which generally becomes effective on January 1, 2002. This Act, among other things, changes federal estate taxes in ways that will impact Virginia estate tax revenues.

The new federal Act alters federal estate tax law in three major respects.

1. It reduces the amount of the "federal credit" (i.e. pick-up tax) beginning January 1, 2002, by 25% each year until it no longer exists on and after January 1, 2005. Beginning January 1, 2005, the credit is replaced by a deduction that reduces the value of the estate subject to the federal estate tax in an amount equal to all state death taxes actually paid.

2. It increases the amount of the unified credit to $1 million in 2002 and gradually increases the credit applicable to estate taxes to $3.5 million by 2009.

3. It completely repeals federal estate taxes in 2010.

The federal Act provides that all of these changes will sunset in 2011 unless reenacted by Congress.

These three major changes to federal estate tax laws will affect Virginia estate taxes as follows.

- Reduction of federal credit -- Under **current** Virginia law, the gradual reduction of the federal credit beginning January 1, 2002, and its elimination on January 1, 2005, will **not** affect Virginia's estate tax revenues. Section 58.1-901 of the Code of Virginia ties Virginia's definition of the amount of the "federal credit" for purposes of determining the amount of Virginia estate taxes, to the maximum amount of such credit as provided under the federal law as it existed on January 1, 1978. Accordingly, contrary to the results in most other states, reductions to the credit under the new federal law will **not** reduce the credit as currently defined by Virginia, and thus, will not reduce the amount of tax imposed by the Commonwealth.

  Under such circumstances, however, the Commonwealth's estate tax no longer would be a pure "pick-up" tax. That is, to the extent the amount of Virginia's estate tax exceeds the new reduced federal credit, it will constitute an amount that otherwise would not have been paid to the federal government. This situation has not occurred previously because the federal credit formula has remained the same since 1978. Thus, if the General Assembly wishes to phase out Virginia's estate tax on the same schedule as that for the federal credit, then legislative action is required.

- Increase in unified credit -- Virginia conforms to the amount of this credit as it exists in federal law at the time of the decedent's death ("rolling conformity"). The amount of this credit effectively establishes a threshold value below which estates are not taxed. Accordingly, the gradual increase in the credit to $3.5 million by 2009 will reduce Virginia's estate tax revenues more than they would have been reduced under the current schedule that would gradually have increased the credit to $1 million by 2006.

- Repeal of the federal estate tax -- The triggering event for the imposition of the Virginia estate tax is the "transfer of the taxable estate." Section

58.1-901 of the Code of Virginia states that " 'taxable estate' " means 'taxable estate' as defined in § 2051 of the United States Internal Revenue Code of 1954, as amended or renumbered, or the successor provision of the laws of the United States." Unlike the Virginia definition of "federal credit" which has a "fixed" conformity date with federal law of 1978, the Virginia definition of "taxable estate" changes as the federal law changes ("rolling conformity"). Accordingly, when the federal estate tax is repealed in 2010 there will no longer be any "taxable estate." As a result, under current Virginia law, in 2010 there will be no "transfer of the taxable estate," and therefore no imposition and collection of the Virginia estate tax.

Of course, all of these results will be negated beginning in 2011 unless Congress repeals or extends the 2011 sunset date. In addition, the General Assembly may choose to consider legislation to alter the impact of the new federal law on Virginia.

Summary

Virginia has considered death to be a taxable event, at least in terms of imposing an inheritance tax, since 1844. Virginia's inheritance tax created certain minimum exemptions in 1916, was amended in 1934, and remained basically unchanged until 1978. The exemption amounts of $5,000, $2,000, and $1,000, with the passage of time, created the practical requirement that almost every estate (and all involving real estate) faced the task of filing a rather detailed and intricate state inheritance tax return, many of which produced negligible tax revenue for the Commonwealth. The passage by Congress of the 1976 Tax Reform Act helped to provide the impetus for a thorough study of Virginia's inheritance and gift tax laws, which resulted in the repeal of Virginia's old inheritance and gift tax and the enactment of the Virginia Estate Tax in 1978. The new federal Economic Growth and Tax Relief Act of 2001 in time could have a profound impact on Virginia's estate tax, including complete elimination in 2010. The General Assembly may choose to consider legislation that alters the impact.

Cigarette Tax

Cigarette Tax

History

Virginia first imposed a state cigarette tax effective October 1, 1960, at a rate of three cents per pack. A similar tax was also imposed on cigars. The tax rate on cigarettes remained at three cents per pack until 1966, when Virginia imposed a sales and use tax and simultaneously lowered the cigarette tax to 2.5 cents per pack,[1] where it remains.

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[1]Va. *Code* § 58.1-1001.

Table 1 indicates state cigarette tax revenues have been relatively stable during the past 10 years. The Commonwealth's revenue from this tax source last year was less than it was in fiscal year 1990-91, even though the general fund has almost doubled during the same period. The tax comprises approximately one-tenth of one percent of the general fund.

TABLE 1
Cigarette Tax Collections
Fiscal Years 1991 - 2000

Fiscal Year Ending June 30	Collections	% Change From Previous Year
1991	$15,294,000	-5.4
1992	$15,152,000	-0.9
1993	$14,789,000	-2.4
1994	$14,881,000	+0.6
1995	$15,811,000	+6.2
1996	$15,950,000	+0.9
1997	$16,035,000	+0.5
1998	$15,728,000	-1.9
1999	$15,376,000	-2.2
2000	$15,208,000	-1.1

Cigarettes are clearly one of the most heavily taxed commodities, if not the most heavily taxed, in the United States. Cigarettes are subject to a 34-cents-per-pack federal excise tax (scheduled to increase to 39 cents in 2002), an extremely high state cigarette tax in almost all states, state and local sales and use taxes, and (in six states) local cigarette taxes. To place the burden in perspective, in 17 states total federal and state cigarette taxes alone equaled at least 50 percent of the average price of cigarettes.

During the past decade, total cigarette sales in both the United States and Virginia have experienced very slight declines, while per capita sales have declined significantly. The Tobacco Master Settlement agreement and the associated cigarette price increase have accelerated the decline of cigarette sales. Revenues from state cigarette tax revenue over the course of the next few years will likely decline even faster as fewer and fewer consumers choose to use tobacco products, and such revenues will become an even smaller component of the general fund.

Tax Rate

Comparison With Other States

Virginia's state cigarette tax of 2.5 cents per pack is the lowest state cigarette tax in the nation. The tobacco tax in Virginia is levied on cigarettes only and does not apply to cigars or chewing tobacco. North Carolina had the lowest rate until it raised the tax to five cents per pack in 1991. Most of the states have cigarette taxes significantly higher than Virginia's (see Table 2). Kentucky (three cents) and South Carolina (seven cents) are the only other states with state cigarette tax rates less than 12 cents. Alaska, Hawaii and New York impose rates of one dollar or more per pack.

TABLE 2
State Cigarette Tax Rates as of July, 2000

State	Cents Per Pack	State	Cents Per Pack
Alabama*	16.5*	Missouri*	17.0*
Alaska	$1.00	Montana	18.0
Arizona	58.0	Nebraska	34.0
Arkansas	31.5	Nevada	35.0
California	87.0	New Hampshire	52.0
Colorado	20.0	New Jersey	80.0
Connecticut	50.0	New Mexico	21.0
Delaware	24.0	New York*	$1.11
District of Columbia	65.0	North Carolina	5.0
Florida	33.9	North Dakota	44.0
Georgia	12.0	Ohio	24.0
Hawaii	$1.00	Oklahoma	23.0
Idaho	28.0	Oregon	68.0
Illinois*	58.0	Pennsylvania	31.0
Indiana	15.5	Rhode Island	71.0
Iowa	36.0	South Carolina	7.0
Kansas	24.0	South Dakota	33.0
Kentucky	3.0	Tennessee*	13.0*
Louisiana	20.0	Texas	41.0
Maine	74.0	Utah	51.5
Maryland	66.0	Vermont	44.0
Massachusetts	76.0	**VIRGINIA***	**2.5***
Michigan	75.0	Washington	82.5
Minnesota	48.0	West Virginia	17.0
Mississippi	18.0	Wisconsin	59.0
		Wyoming	12.0

**Allows local taxes to be imposed in at least one locality.*
NOTE: The federal cigarette excise tax is 34 cents per pack.
SOURCE: Federation of Tax Administrators.

Local Taxes

In addition to state cigarette taxes, Virginia is one of six states where selected localities are permitted to impose local cigarette taxes. In 1999, two counties, 25 cities and a number of towns levied local cigarette taxes, which generated almost $35 million in revenue. The rates of local cigarette taxes in counties and cities ranged from four cents to 30 cents per pack in 1999. In 1999, Virginia Beach collected $7.5 million from its local cigarette tax, while Norfolk collected $4.9 million. These two localities collected more than 80 percent of what the entire state received from its state cigarette tax (see Table 3).

TABLE 3
Virginia's Local Cigarette Tax Rates and Collections
1999

Locality	Tax Rate (¢ Per Pack)	Local Cigarette Tax Revenues
Counties		
Arlington	5¢	$613,199
Fairfax	5¢	1,903,281
Subtotal		**$2,516,480**
Cities		
Alexandria	20¢	$1,649,055
Bedford	10¢	110,948
Bristol	4¢	169,282
Charlottesville	12¢	422,083
Chesapeake	25¢	3,006,897
Clifton Forge	4¢	17,661
Fairfax	25¢	568,981
Falls Church	25¢	253,632
Franklin	25¢	NA
Fredericksburg	5¢	127,266
Hampton	35¢	2,413,055
Lynchburg	15¢	796,774
Manassas	15¢	383,893
Manassas Park	15¢	94,303
Newport News	25¢	3,271,271
Norfolk	30¢	4,918,212
Petersburg	10¢	188,070
Portsmouth	20¢	1,871,966
Roanoke	17¢	1,322,808
Suffolk	30¢	946,955
Virginia Beach	27¢	7,480,324
Waynesboro	4¢	120,735
Winchester	10¢	357,052
Subtotal **$30,491,263**		
Towns		
Blacksburg	10¢	211,284
Bluefield	2¢	67,392
Chilhowie	2¢	NA
Culpeper	10¢	208,326
Grundy	2¢	NA
Herndon	20¢	233,508
Leesburg	25¢	507,213
Marion	2¢	43,010
Pulaski	10¢	172,740
Purcellville	20¢	NA
Saltville	5¢	NA
Vienna	20¢	206,837
Warrenton	15¢	233,690
Wytheville	3¢	64,886
Total: **$34,956,629**		

SOURCE: *Comparative Report of Local Government*, Fiscal year ended June 30, 1999, Auditor of Public Accounts.
1999 Local Tax Rates, Weldon Cooper Center for Public Service, University of Virginia, Charlottesville, Virginia.

As a practical matter, the state cigarette tax of 2.5 cents per pack is completely dwarfed by the localities in Virginia that choose to impose local cigarette taxes. Five cities have local cigarette taxes of 25 cents per pack, which is ten times greater than the state cigarette tax. Hampton imposes the highest local tax at 35 cents per pack while Norfolk and Suffolk have the next highest tax rate at 30 cents per pack. It appears that Virginia's high local taxes affect sales of cigarettes in Virginia, and therefore the Commonwealth's revenue, because taxes are one determinant of sales, especially in border areas. For example, North Carolina and Kentucky, with the second and third lowest state cigarette taxes, respectively, have the two highest per capita sales of cigarettes in the country. Virginia, however, with **the lowest** state cigarette tax, is ranked only 16th in terms of per capita cigarette sales.

Tax Administration

The administration of the state cigarette tax is relatively straightforward, with most states utilizing a tax stamp to indicate payment of the tax. The stamp is affixed to the pack by the wholesaler or distributor, and the tax must be paid, in most states, by the 15th or 20th day of the following month. Virginia requires payment to the Department of Taxation by the 10th day of the following month.[2] Virginia is one of 45 states and the District of Columbia that utilizes this tax stamp method to indicate payment of the tax.

Virginia also provides the wholesale dealer a commission of 10 percent of the amount of the state tax as compensation for the costs associated with affixing the tax stamp and collecting the tax.[3] Although the Commonwealth provides compensation for the collection of a number of state taxes, the cigarette tax compensation of 10 percent, increased from five percent in 1973, is the largest percentage commission paid by the Commonwealth. Virtually all states provide a commission to the wholesalers who administer the tax. Although Virginia provides a high percentage commission, it is based on a low cigarette tax, and the actual compensation paid is therefore relatively small compared to the other states. Table 4 provides a comparison of commissions paid by other states. Virginia's localities also provide compensation for the administration of the local cigarette tax.

Five states (Alaska, Hawaii, Michigan, North Carolina, and North Dakota) do not use tax stamps in the administration of their state cigarette tax. Michigan was the first state to attempt to reduce the administrative costs and burden by switching from a tax stamp method to a reporting method, which eliminates the costs of the stamp and the expenses associated with affixing the stamp to the cigarettes. The tax relies upon the wholesaler or distributor reporting cigarette sales to the appropriate state. Of course, the Department of Taxation in those states audits the records of the wholesaler to ensure the proper payment of the tax. This reporting procedure appears to be a more efficient way of

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[2]Va. *Code* § 58.1-1008 (1984).

[3]Va. *Code* § 58.1-1009 (1984).

TABLE 4

Discounts on Cigarette Tax Stamp Purchases, July 1999

State	%	Discount Per Case	State	%	Discount Per Case
Alabama	7.50	$7.43	Nevada	3.00	$6.30
Alaska	1.00	2.40	New Hampshire		
Arizona			first $500,000	2.75	8.58
first $36,000	4.00	13.92	next $500,000	2.375	7.41
next $36,000	3.00	10.44	over $1 million	2.00	6.24
over $72,000	2.00	6.96	New Jersey	1.12	5.40
Arkansas	3.80	7.18	New Mexico		
California	0.85	4.437	first $30,000	4.00	5.04
Colorado	4.00	4.80	next $30,000	3.00	3.78
Connecticut	1.00	3.00	New York		
Delaware	2.14	3.08	first $3,306,600	.37	1.24
Dist. of Columbia	2.00	7.80	over $3,306,600	.26	0.88
Florida	2.00	2.88	North Carolina	4.00	1.20
Georgia	3.00	2.16	North Dakota	1.00	2.64
Hawaii	0	0.00	$100 per month max		
Idaho	5.00	8.40	Ohio	3.60	5.18
Illinois			Oklahoma	4.00	5.52
first $3 million	1.75	6.09	Oregon		
additional	1.5	5.22	first 26,000 cases	.889	1.49
Indiana	4.00	3.72	over 26,000 cases	.667	1.12
Iowa	2.00	4.32	Pennsylvania	3.00	5.58
Kansas	2.65	3.82	Rhode Island	1.25	5.33
Kentucky	9.09	1.64	South Carolina	3.50	1.47
Louisiana	6.00	7.20	South Dakota	3.50	6.93
Maine	2.50	11.10	Tennessee		
Maryland	0.82	3.25	first 3,000 cases	2.75	2.14
Massachusetts	0.99	1.85	next 3,000 cases	2.50	1.95
Michigan	1.25	5.63	next 9,000 cases	2.25	1.75
Minnesota			over 15,000 cases	1.75	1.36
first $1.5 million	1.00	2.88	Texas	3.00	7.38
additional	0.60	1.73	Utah	4.00	12.36
Mississippi	6.44	6.96	Vermont	2.30	6.07
Missouri	3.00	3.06	Virginia	10.00	1.50
Montana			Washington	1.23	2.40
first 2,580	6.00	6.48	West Virginia	4.00	4.08
cartons					
next 2,580	4.00	4.32	Wisconsin	1.60	5.86
over 5,160	3.00	3.24	Wyoming	6.00	4.32
Nebraska	3.40	6.93			

Case = 600 packs

NOTE: Hawaii pays no commission.

SOURCE: Tobacco Merchants Association of the United States, Princeton, New Jersey.

administering the tax, especially given the relatively small dollar amounts associated with the cigarette tax, and would allow the state to reduce the amount of compensation paid to the wholesalers or dealers for the administration of the tax. Based on Virginia's collections of $15.2 million in 2000, the Commonwealth paid approximately $1.5 million to wholesale dealers for the administration of the tax.

The Commonwealth has had other taxes in the past that utilized some type of indicia method of indicating that the appropriate amount of tax had been paid. One example is the beer and beverage excise tax, where a stamp, crown, or lid was affixed to the container to indicate the state tax was paid. This method was eliminated on July 1, 1972.[4] It should be noted that no commission was provided as compensation for affixing the stamp, crown, or lid. However, the 1978 Session of the General Assembly enacted legislation effective July 1, 1980, which provided a one percent commission to the wholesale dealer for the administration of the beer and beverage excise tax, and it is still in effect.[5]

Issues

Collection System

If Virginia were to consider switching from the stamp system to a reporting system, the Commonwealth could save up to $1.5 million per year in payments made to the wholesalers for affixing the tobacco stamp. For example, if the Commonwealth paid a three percent commission for collecting the tax in contrast to the current 10 percent, the savings would be about $1.0 million per year.

Tax Rate

Table 5 shows the estimated revenue that would be generated by several sample state cigarette tax rate increases, based on fiscal year 2000 collections.

TABLE 5
Estimated Revenues from Increased Tax Rates

Tax	Estimated Revenue	Change From Current Tax
2½ ¢ (current)	$15.2 million (2000)	
5¢	$30.4 million	+ $15.2 million
7½ ¢	$45.6 million	+ $30.4 million
10¢	$60.8 million	+ $45.6 million

Tax on Manufacturers

The changing nature of the tobacco industry, with the decline in U.S. consumption and the increase in the exports of cigarettes, has caused at least two states (Virginia and North Carolina) to consider a tax on cigarettes manufactured in their states. This type of tax is simply a tax imposed on each cigarette manufactured regardless of where it is sold. Because the vast majority of cigarette manufacturing is in Virginia and North Carolina, these are the only two states where such a plan has been proposed.

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[4] Chapter 784, *Acts of Assembly, 1970*.
[5] Chapter 795, *Acts of Assembly, 1978*.

The legislation introduced at various times in the 1990s proposed a tax of 0.5 mills per cigarette manufactured in Virginia. One mill is equal to one-tenth of a cent, and thus, a 0.5 mills tax on a pack of 20 cigarettes would equal a one-cent tax. The tax would be imposed regardless of the point of destination, and therefore, the tax could be borne by consumers worldwide. Of course, the disadvantage to this tax is that it could place Virginia at a competitive disadvantage with North Carolina and other tobacco producing states and could cause manufacturers to shift production (and the resulting employment, income and profit) to another state.

Summary

The state cigarette tax generates a relatively small amount of revenue for the general fund and will likely continue to decline in importance. Virginia's state tax is the lowest in the United States and could be increased significantly and still be in line with other states. However, it is also clear that Virginia's localities tax cigarettes at extremely high rates and place Virginia in a position of losing sales to other states, especially in the border areas.

In particular, Virginia could significantly increase its **state** cigarette tax and still be low relative to other states. For example, an increase from 2.5 cents to 10 cents per pack (a 300 percent increase) would still leave Virginia with the 47th lowest state tax rate in the country. However, if one compares state and local cigarette taxes, the situation is much different. If state and local taxes are considered, Virginia's current combined tax equals 37.5 cents per pack in some localities, which is well above the median rate. If the state tax rate were to increase to 10 cents per pack, Virginia's combined tax, in some localities, would be 45 cents per pack, and would leave those Virginia localities with the 21st highest tax rate among the states.

Enforcement and Collection of State Taxes

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Enforcement and Collection of State Taxes

History

State tax assessment and collection procedures directly affect the Commonwealth's general fund. The proper assessment of taxes by the Department of Taxation and timely payment by the taxpayer reduce the cost of administration and maximize the availability of general fund revenues for other purposes. Nevertheless, because erroneous tax assessments and delinquent tax payments occur, administrative and judicial remedies are available to augment the tax collection and refund procedures in the Commonwealth.

Prior to 1980, Virginia's administrative and judicial tax procedures were unstructured due to a lack of written tax regulations and legal precedent.[1] When taxpayers questioned the Department's interpretation of statutory provisions, the Tax Commissioner issued individual letters establishing the state's tax policy. Because no other written tax regulations existed (except for sales and use tax), the commissioner's interpretations were given great deference by the courts. As a result, the Commonwealth's tax procedures confused both taxpayers and tax practitioners.

In 1978, a joint task force comprised of members of the taxation committees of the Virginia Bar Association, Virginia State Bar, and the Virginia Society of Certified Public Accountants conducted a study on Virginia's tax procedures.[2] The task force examined Virginia's practices relating to administrative and judicial correction procedures, refund procedures, levy and collection of taxes, and penalties. The task force identified specific problems in the tax procedures, which included inadequate refund procedures and an absence of written regulations.[3]

1980 Changes

As a result of this task force's study, the 1979 General Assembly adopted House Joint Resolution No. 342 to further examine the Commonwealth's tax procedures. The joint subcommittee concurred with the findings of the task force and recommended substantial revisions to the tax procedures, which were enacted by the General Assembly in Chapter 633, *Acts of Assembly*, 1980. Chapter 633 made the following changes:

1. Required the publication of written regulations by the Department pursuant to the Administrative Process Act;

2. Revised and clarified the period of limitations for the assessment of taxes by the Department;

3. Reduced the time for the Tax Commissioner to employ the automatic right to a rehearing from six months after a circuit court decision to 21 days from the date the circuit court order is certified by the clerk;[4] and

4. Added definitions to clarify the standing and limitation provisions for persons assessed with state taxes.

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[1] Phillips, *Virginia Tax Procedures: Unfinished Business*, 38 Washington & Lee L. Rev. 1115 (1981).

[2] *Id.*, at 1116.

[3] *Report of the Practices and Procedures in the Collection and Administration of State Taxes Study Committee*, House Document No. 30 (1980).

[4] In 1984, the Commissioner's automatic right to a rehearing was repealed pursuant to Chapter 675 (*Acts of Assembly,* 1984).

Although the joint subcommittee recommended the creation of an administrative review board, known as the Virginia Board of Tax Appeals, to hear decisions appealed from the Department, this recommendation was not enacted by the General Assembly.[5]

The revised administrative and judicial tax procedures enacted by the 1980 General Assembly are substantially the same tax collection and refund procedures that exist in the Commonwealth today.

Virginia Taxpayer Bill of Rights

The Virginia Taxpayer Bill of Rights was passed by the 1996 General Assembly and went into effect July 1, 1997. The purpose of the bill of rights is to guarantee that (i) the rights, privacy, and property of Virginia taxpayers are adequately protected throughout all tax assessment, collection and enforcement procedures under the Commonwealth's revenue laws; and (ii) the taxpayer is treated with respect.[6]

The Taxpayer Bill of Rights contains short but comprehensive statements that explain in simple terms the rights and obligations of the Department of Taxation and taxpayers. There are 13 "rights" outlined in § 58.1-1845 ranging from "the right to...prompt, courteous and accurate responses to questions and requests for tax assistance" to "the right to procedures which assure that the individual employees of the Department [of Taxation] are not paid, evaluated, or promoted on the basis of assessments or collections from taxpayers...."

Collection of Delinquent Taxes by the Department of Taxation

State tax administrators are authorized to employ a variety of legal procedures to collect delinquent tax assessments. Although most taxpayers submit timely payments, the Department estimates that the legal procedures are essential in collecting taxes from approximately five percent of the individual and two percent of the business taxpayers who are delinquent in paying state taxes to the Commonwealth.

An assessment is made by the Department when written notice of assessment is delivered to the taxpayer by an employee of the Department or the date when the assessment is mailed to the taxpayer's last known address.[7] An assessment shall also be deemed made when a notice of assessment is sent by the Department to the taxpayer by either facsimile transmission or electronic mail, as approved and designated by the

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[5] Phillips, supra note 1, n. 32, at 1121. *"The recommended revisions to the statute of limitations included allowing a taxpayer a three-year period from the date the Department mailed the notice of assessment to contest it before the Tax Commissioner or courts, allowing the taxpayer to file a protective claim for refund if the taxpayer contests before the Tax Commissioner which extends the statute of limitations one year until the Commissioner makes a final decision and allowing the limitations period to run three years from the date the tax was due or paid (whichever is later) rather than from December 31 after that date."*

[6] *Va. Code* § 58.1-1845 (2000).

[7] Va. *Code* § 58.1-1820 (2000).

taxpayer in writing.[8] Payment of a tax is delinquent if it is not paid within 30 days from the date the assessment is made.[9]

When a tax is delinquent, the Department attempts to collect the tax by sending two additional assessment notices to the taxpayer before referring the delinquent tax to the its Delinquent Collections Unit. Typically, the Department allows business taxpayers about 130 days from the assessment date and individual taxpayers 70 days from the assessment date before it files a memorandum of lien in the circuit court.

The lien is filed in any county or city where the taxpayer's business is located, where the taxpayer resides, or in every county or city in which the taxpayer owns real estate. If the taxpayer has no residence or business in the Commonwealth, the lien may be filed in the Circuit Court of the City of Richmond. The lien attaches to the taxpayer's real estate and personal property located in the respective jurisdiction and allows the Department, after following proper legal procedures, to have the property sold to satisfy payment of the delinquent taxes.[10]

The Department of Taxation estimates that about 45 percent of delinquent tax collections are made after the Department files a memorandum of lien or third party lien. During fiscal year 1999, the Department reported collecting $306,138,538 in delinquent taxes.

The Department may also impose penalties and interest upon a taxpayer for failing to file a proper return or failing to pay the full amount of tax due. The penalty is five percent of the amount of tax due for each month of delinquency up to a maximum penalty of twenty-five percent of the amount of tax due.[11] No penalty or interest can be imposed on any tax assessment for the recovery of erroneous refunds that occur as a result of an error by the Department, as long as the tax due is remitted to the Department within 30 days of the tax bill.[12]

If the taxpayer's failure to pay the tax in full was fraudulent, a penalty of 100 percent of the tax due is assessed.[13] The Department estimates that it collected $21,828,963 in penalties from delinquent business taxpayers and $34,596,419 from delinquent individual taxpayers in fiscal year 2000.

The Department must assess taxes within three years from the date the return was filed, or if no return was filed, the assessment must be made within six years from the date the return was due.[14] However, the Department and the taxpayer may waive this statute

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[8] *Id*.

[9] Va. *Code* § 58.1-1812 (2000).

[10] Va. *Code* § 58.1-1805 (2000).

[11] Va. *Code* § 58.1-1812 (2000).

[12] *Id.*

[13] *Id.*

[14] Va. *Code* § 58.1-1812 (2000).

of limitations on assessments by written agreement.[15] There is no period of limitation on assessments if a false or fraudulent return is filed with intent to evade payment of the tax.[16] Additionally, criminal liability and 100 percent liability are imposed upon officers of a corporation or partnership for willful failure to file a return, keep records, or supply information to the Department.[17]

Beginning on July 1, 1989, the Tax Commissioner received additional authority to enhance tax collections from delinquent businesses. The Tax Commissioner may padlock the doors of any business delinquent in filing or paying taxes owed the Commonwealth after the commissioner has filed a lien in the circuit court and if he determines that padlocking the premises is in the Commonwealth's best interest.[18] If the tax deficiency is not paid within three business days, the commissioner may sell the business property to satisfy the lien.[19] The taxpayer may appeal the Tax Commissioner's memorandum of lien if the taxpayer alleges an error in the lien filing. The Tax Commissioner then has 14 days to make a determination regarding the appeal.[20] The Tax Commissioner has promulgated regulations setting forth the circumstances when he may place padlocks on the doors of businesses.[21]

Four additional statutory procedures exist that allow taxpayers to challenge tax assessments:

1. The taxpayer may file an application for correction with the Tax Commissioner;[22]

2. The taxpayer may file an amended tax return;[23]

3. The taxpayer may pay the tax or post a bond and apply directly to the circuit court for relief;[24] or

4. The taxpayer may file an application for correction, or amended return, pay the tax, and file a protective refund claim to preserve the right to proceed in the circuit court after the Tax Commissioner issues a final ruling.[25]

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[15] Va. *Code* § 58.1-220 (2000).
[16] Va. *Code* § 58.1-1812 (2000).
[17] Va. *Code* § 58.1-1813 (2000).
[18] Va. *Code* § 58.1-1805 (2000).
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] Va. *Code* § 58.1-1821 (2000).
[23] Va. *Code* § 58.1-1823 (2000).
[24] Va. *Code* § 58.1-1825 (2000).
[25] Va. *Code* § 58.1-1824 (2000).

Administrative Remedies

Application to Tax Commissioner

Any taxpayer may file an application with the Tax Commissioner to correct an erroneous assessment within 90 days after the assessment date. Payment of the tax prior to filing the application is unnecessary, unless the Tax Commissioner determines that collection of the tax is in jeopardy.[26] The Tax Commissioner considers the evidence submitted relating to the assessment and determines whether the assessment is correct. If the Tax Commissioner determines the assessment exceeds the proper amount, the commissioner can either order the taxpayer exempt from payment of the erroneous amount or refund any amount improperly collected from the taxpayer.[27] In fiscal year 2000, approximately 0.05 percent of the Commonwealth's taxpayers filed applications for correction with the Tax Commissioner. The Department resolved 181 appeals and 1,440 offers in compromise during fiscal year 2000, representing a total assessed amount of approximately $47.4 million.

Filing An Amended Return

A taxpayer may also file an amended return within three years from the last date for timely filing of the return or within one year from a final determination of any federal income tax liability that is the basis for the Virginia individual income tax.[28] The Department of Taxation may either refund any amount that the taxpayer overpaid or reassess the taxpayer. If the department denies the refund or fails to respond within three months, the taxpayer may subsequently pursue judicial remedies if he has paid the tax.

In addition, according to § 58.1-1824, any taxpayer who has paid the assessed state taxes may preserve his judicial remedies by filing a refund claim with the Tax Commissioner within three years of the assessment date. Within one year after the Tax Commissioner's decision, the taxpayer may apply to the circuit court for relief.

Judicial Remedies

Application to Circuit Court

A taxpayer must have paid the tax assessment or posted bond with surety to apply directly to the circuit court for relief of an erroneous tax assessment. The application must be filed within three years from the assessment date.[29] Instead of filing for correction directly with the circuit court, any taxpayer who has paid the tax and applied for administrative relief from the Tax Commissioner may also file for relief in the circuit court

[26] Va. *Code* § 58.1-1821 (2000).
[27] *Va. Code* § 58.1-1822 (2000).
[28] Va. *Code* § 58.1-1823 (2000).
[29] Va. *Code* § 58.1-1825 (2000).

within one year from the Tax Commissioner's final ruling on the correction of an erroneous assessment or amended return, provided the taxpayer filed a protective refund claim, which extends the statute of limitations and preserves the right to proceed judicially.[30] In every judicial proceeding, the taxpayer bears the burden of establishing that the correction or assessment is erroneous.

Generally, assessments are presumed correct and courts will not disturb them unless the applicant clearly establishes that the assessment is erroneous.[31] A court can order a correction of the assessment, exoneration from payment on a refund, or payment of the tax if there is an underpayment.[32] Any taxpayer or the Tax Department can appeal any circuit court decision to the Supreme Court of Virginia.[33]

In fiscal year 2000, fewer than 1 out of every 250,000 taxpayers in the Commonwealth filed an application for correction of erroneous assessment with the circuit court. Furthermore, only seven taxpayers filed applications to the circuit court and no taxpayers appealed circuit court decisions to the Supreme Court in fiscal year 2000, according to the Department of Taxation.

Summary

The Commonwealth's procedures relating to the collection, enforcement, and remedies available for state tax assessments provide taxpayers and tax administrators with a variety of options to resolve disputes about tax assessments.

Taxpayers can challenge erroneous assessments by (i) applying to the Tax Commissioner for correction, (ii) filing an amended return, or (iii) paying the tax and applying directly to the circuit court for relief. Taxpayers have substantial flexibility in deciding whether to pursue remedies administratively, judicially, or both.

Similarly, tax administrators are authorized to employ a variety of procedures to collect delinquent tax assessments, such as filing a memorandum of lien, imposing penalties and interest, or seizing the property of certain delinquent taxpayers.

Collection and refund tax procedures are significant components in the Virginia tax scheme, because definite yet flexible standards reduce the cost and complexity of taxpayer compliance and tax administration in the Commonwealth.

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[30] Va. *Code* § 58.1-1824 (2000).
[31] Va. *Code* § 58.1-1825 (2000).
[32] Va. *Code* § 58.1-1826 (2000).
[33] Va. *Code* § 58.1-1828 (2000).

Public Service Corporation Taxes/ Energy Consumption Taxes

Public Service Corporation Taxes/Energy Consumption Taxes

Gross Receipts Tax on Public Service Corporations

History

The state gross receipts tax on public service corporations in Virginia was first imposed in 1898 when the General Assembly adopted a franchise tax based on gross receipts for telegraph companies at a rate of two percent. When the Constitution of 1902 was adopted and the State Corporation Commission was established, the General Assembly extended this tax to railroads at a rate of one percent of gross receipts and to telephone companies at a rate of two percent of their intrastate gross receipts.

In 1916, the General Assembly expanded the state gross receipts tax to include water, heat, light, and power companies at the rate of 0.75 percent of their gross receipts. Table 1 lists the dates the original gross receipts tax rates were adopted and the rate for each public service industry. These tax rates have been changed by the General Assembly from time to time over the years.

TABLE 1

ORIGINAL YEAR OF ADOPTION AND TAX RATE OF VIRGINIA'S GROSS RECEIPTS TAXES ON PUBLIC SERVICE CORPORATIONS

YEAR	**PUBLIC SERVICE CORPORATION**	**TAX RATE**
1898	Telegraph	2%
1902	Railroads	1%
1902	Telephone	2%
1916	Water, heat, light, and power	0.75%

Current System of Taxing

The gross receipts tax on public service corporations is administered by the State Corporation Commission. The tax is imposed on all revenue derived in the Commonwealth by the public service corporation. The tax rate currently is set at two percent.[1]

This method of taxation differs from the predominant way in which other corporations are taxed in the Commonwealth pursuant to the corporate income tax. The Virginia corporate income tax is basically a tax on profits rather than gross receipts. The gross receipts tax, also called a "license tax" or "franchise tax," historically has been justified as a tax on the privilege granted to public service corporations to operate exclusive public service franchises in the Commonwealth.

Revenues from the gross receipts tax amounted to $111,949,000 and $104,197,000 for fiscal years 1999 and 2000 respectively.[2] These amounts accounted for about one percent of the total general fund revenues collected in the respective fiscal years. Table 2 shows the revenue generated by the gross receipts tax for fiscal years 1990 through 2000. These revenues will decrease dramatically as the electric and gas industries soon will no longer be subject to the gross receipts tax as explained below.

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[1] Va. Code § 58.1-2626 (2000).

[2] Department of Accounts *Summary Report on General Fund Revenue Collections for Fiscal Years 1999 and 2000*.

TABLE 2
GROSS RECEIPTS TAX REVENUE
FROM PUBLIC SERVICE CORPORATIONS

FISCAL YEAR	REVENUE
2000	$104,197,000
1999	$111,949,000
1998	$101,782,000
1997	$126,283,000
1996	$115,509,000
1995	$108,637,000
1994	$118,743,000
1993	$97,797,000
1992	$102,354,000
1991	$95,488,000
1990	$101,591,000

Source: Department of Accounts Summary Reports on General Fund Revenues for Fiscal Years 1990 through 2000.

Reduction in Scope of Industries Covered

As market competition gradually has replaced exclusive "franchises" among public service corporations, similarly the corporate income tax gradually has replaced the gross receipts tax. Railroads and telecommunications companies ceased being subject to the gross receipts tax in 1978 and 1988, respectively, and, instead, became subject to the corporate income tax.

As part of the process of moving the energy industry to market competition, in 1999 and 2000 the General Assembly enacted legislation that ends the gross receipts tax on electric power companies and gas power companies, respectively, on January 1, 2002, and replaces it with the corporate income tax and energy consumption taxes effective January 1, 2001 (see chapter on Corporate Income Tax herein for discussion of corporate income taxes, and see immediately below for discussion of energy consumption taxes). Because the final gross receipts tax that will be paid by these companies in 2001 is based on gross receipts received in 2000, and the first corporate income tax will be paid in 2002 based on income received in 2001, the transition avoids "double taxation."

Accordingly, the only entities remaining liable under the state gross receipts tax for gross receipts received after January 1, 2001, are water companies. Because the revenue from gross receipts tax on water companies historically comprise less than one percent of the total gross receipts taxes collected, soon the revenue from the gross receipts tax on public service companies will become a relatively insignificant component of the general fund.

Electric Utility Consumption Tax

A new electric utility consumption tax is effective January 1, 2001. This tax is in lieu of and replaces (1) the state gross receipts tax on electric utility companies, (2) the special regulatory tax on such companies for the cost of regulation by the State Corporation Commission, and (3) the local license tax on these companies (local option to impose tax up to 0.5 percent of gross receipts).[3]

The new tax is imposed on all consumers of electricity in the Commonwealth (except, under certain conditions, consumers who purchase electricity from municipality-owned electric companies, or from a utilities consumer services cooperative) based on kilowatt hours ("KWh") used per month, according to the following schedule:

KWh Used	Rate
0 - 2,500	$0.001555/KWh
2,501 - 50,000	$0.00099/KWh
over 50,000	$0.00075/KWh[4]

The revenue generated by this tax is divided according to a set formula among (1) the Commonwealth's general fund, (2) the State Corporation Commission's special regulatory fund, and (3) localities according to point of consumption.[5] The formula for the amount to be distributed to each of these entities is calculated with the intent to replace the amount of revenues each would have generated by the aforementioned taxes and fees replaced by the consumption tax.

In this regard, the portion earmarked for localities is based on the estimated revenues that would have been generated by the local license tax statewide. However, it is a local option to decide whether to impose such a tax and, if so imposed, at what rate (up to 0.5 percent).[6] Accordingly, if a locality imposes less than the maximum local license tax rate as of December 31, 2000, the amount by which the portion of the consumption tax earmarked for that locality exceeds the revenues that would have been generated by the local license tax for that locality goes to the Commonwealth.[7]

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[3]Va. Code § 58.1-2900 et seq (2000).
[4]Va. Code § 58.1-2900 A (2000).
[5]Va. Code § 58.1-2900 (2000).
[6]Va. Code § 58.1-3731 (2000).
[7]Va. Code § 58.1-2901 F (2000).

Natural Gas Consumption Tax

There is a new natural gas consumption tax effective January 1, 2001, that parallels the structure of the electric utility consumption tax.[8] Under this tax, all consumers of natural gas (except consumers served by a gas utility owned or operated by a municipality) will pay taxes based on the number of cubic feet of gas used per month.[9] This tax replaces and is in lieu of the state gross receipts tax on gas companies, the special regulatory fee charged by the State Corporation Commission to gas companies, and the local license tax on gas companies.[10]

The gas consumption tax is imposed only on the first 50,000 cubic feet of gas used per month.[11] The rate of the tax is $0.0195 per 100 cubic feet of gas used per month. The revenues generated by this tax are divided according to a set formula among (1) the Commonwealth's general fund, (2) the State Corporation Commission's special regulatory fund, and (3) localities according to point of consumption. The formula for the amount to be distributed to each of these entities is calculated to replace the amount of revenues each would have generated by the aforementioned taxes and fees replaced by the natural gas consumption tax.[12]

Issues

The major issues regarding the foregoing taxes relate to the impending transition from the state gross receipts tax on electric and gas power companies to the corporate income tax on such companies, combined with electric and gas consumption taxes to be paid by residential and commercial users. As with any new taxes, there are questions as to how much revenue they will generate, and how smoothly they will be administered.

In addition, it will be important to observe the public's reaction to the new consumption taxes on electricity and gas. In particular, even though the amounts represented by these taxes were previously "passed on" to consumers in the rates they were charged, they may be perceived by some as "new taxes."

Summary

As market competition gradually has replaced exclusive "franchises" among public service corporations, the corporate income tax gradually has replaced the gross receipts tax. Beginning with removal of the railroads and telecommunications industries, and then more recently with the electric and natural gas industries, the number of industries subject to the state gross receipts tax has dwindled so that soon the only public service corporations that will be subject to the tax will be water companies.

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[8] Va. Code § 58.1-2904 et seq (2000).
[9] Va. Code § 58.1-2904 A (2000).
[10] Va. Code § 58.1-2904 B (2000).
[11] Va. Code § 58.1-2904 A (2000).
[12] Va. Code §§ 58.1-2904 and 58.1-2905 (2000).

Summary (continued)

In addition to the corporate income tax, new consumption taxes on the use of electricity and natural gas will replace revenues given up by the repeal of (i) the gross receipts tax on electric and gas companies, (ii) the State Corporation Commission's special regulatory fee on electric and gas companies, and (iii) the local license tax on these companies.

Insurance Premiums Tax

History

Insurance Premiums Tax Structure and Tax Rates

Comparison with other States

Issues

Retaliatory Tax Credit
Revenues Dedicated to Transportation Initiatives

Summary

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Insurance Premiums Tax

History

In 1842, Virginia levied an annual tax of $100 on each insurance office in the Commonwealth. Insurance premiums were first taxed by Virginia in 1856 when it levied a tax of 0.5 percent on the gross premiums of insurance companies doing business in Virginia but chartered outside of the Commonwealth. In 1873, the gross premiums tax was increased to 1.5 percent, and its reach was expanded to include the gross premiums of both foreign and domestic insurers. The tax on insurance premiums was reduced to one percent in 1874. That same year Virginia also adopted a retaliatory tax.

Based on findings of the 1914 Report of the Joint Commission on Tax Revision, the 1915 General Assembly established separate gross premium tax rates according to company type: sick benefit companies (one percent), life insurance companies (2.25 percent), and fire and marine, surety, health and accident, and other companies (2.75 percent). In addition, insurers were made exempt from most state and local taxes;

however, insurers were still subject to assessment fees; charter, franchise and registration charges; and local property taxes. In 1987, the gross premiums tax on fire and marine, surety, health and accident, and other companies was reduced from 2.75 percent to 2.25 percent.

The 1990s saw the General Assembly pass legislation providing for assessments on specific types of insurance policies. The General Assembly provided for a one percent tax on the gross premiums from flood insurance policies to fund flood prevention programs (1990) and a 0.25 percent tax on the gross premiums of certain automobile physical damage insurance policies to fund programs to reduce losses from motor vehicle thefts (1991). In addition, a 0.8 percent fire programs tax enacted in 1985 was increased to one percent in 1995 to fund fire prevention and public safety programs.[1]

Finally, in 1998, Virginia domiciled insurers were allowed a retaliatory tax credit up to the amount of retaliatory taxes and fees they were charged by other states. Other states commonly assess taxes and fees on foreign domiciled insurers (including Virginia insurers) in order to enable their own insurance companies to better compete.

Insurance Premiums Tax Structure and Tax Rates

Insurance premium tax revenues have increased 59 percent during the past decade, from $157.7 million in 1991 to $251.1 million in 2000 (See Table 1). Moreover, these revenues have increased every year since fiscal year 1992, ranging from a high of 10.9 percent in fiscal year 1992 to a low of 0.5 percent in fiscal year 1997. Between 1991 and 2000, insurance premium tax revenues were one of the more stable sources of general fund revenues.

In 1991, insurance premium tax revenues accounted for 2.9 percent of all general fund revenues, making this the fourth largest source of general fund revenues. By 2000, insurance premium tax revenues dipped to 2.3 percent of all general fund revenues, but still were the fourth largest source of general fund revenues.

Insurance premium tax revenues have not experienced the volatility during the past 10 years that has been characteristic of individual income tax revenues and other general fund revenue sources. This is due in part to the fact that there is a strong need for insurance in both good and bad economic times. As a result, consumer buying habits for insurance may be expected to remain relatively constant even as the economy changes. In addition, the structure of the insurance premium tax has remained relatively unchanged during the decade. In comparison, Virginia's individual income tax structure has undergone many changes during the decade.

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[1] This information is paraphrased from House Document No. 78, 1997, *Virginia's Gross Receipts Tax Imposed on Insurance Companies.*

TABLE 1
Insurance Premium Tax Revenues
Fiscal Years 1991 - 2000

Fiscal Year Ending June 30	Tax	% Increase Over Previous Year
1991	$157,677,000	-11.7
1992	$174,788,000	10.9
1993	$180,308,000	3.2
1994	$196,416,000	8.9
1995	$208,225,000	6.0
1996	$218,046,000	4.7
1997	$219,032,000	0.5
1998	$236,971,000	8.2
1999	$244,910,000	3.4
2000	$251,074,000	2.5

SOURCE: *Department of Accounts Summary Report on General Fund and Lottery Revenue Collections (1991-2000).*

The insurance premiums tax is a privilege tax that is administered by the State Corporation Commission. For the privilege of doing business in the Commonwealth, insurance companies are assessed an annual tax measured by their gross income from premium and subscription sales. An insurer's "license" to do business in Virginia runs from July 1 through June 30 of the succeeding year.[2] The due date for payment of the tax to the Commission is March 1.[3]

The cost of obtaining this license or the tax charged for the license is equal to a percentage of the insurer's gross income from premium and subscription sales in Virginia during the previous calendar year. That percentage or the applicable tax rate varies depending on the type of insurance as follows:

- 2.25 percent of the gross income from accident and sickness, fire damage, water damage, burglary and theft, personal injury liability, property damage, credit, title, and motor vehicle damage and liability insurance policies;

- 2.25 percent of the gross income from life insurance and accidental death and dismemberment insurance policies;

- One percent of the gross income from industrial sick benefit insurance policies; and

[2] Va. Code §§ 58.1-2500 and 58.1-2501.
[3] Va. Code § 58.1-2503.

- 0.75 percent of the gross income from subscription contracts to individuals for certain health services and 2.25 percent of the gross income from all other subscription contracts for health services.[4]

Fraternal benefit societies are exempt from the insurance premiums tax. In addition, the tax may not be imposed on workers' compensation insurance premiums and on the consideration paid for contracts for annuities.[5]

Comparison with Other States

All 50 states levy taxes on insurance companies with most states levying a gross receipts tax on insurance premiums.[6] In 1999, Virginia ranked in a tie for 33rd for the lowest tax rates imposed on life insurance premiums (See Table 2). Only 12 states imposed higher taxes on these premiums, and five states charged the same rate as Virginia. Illinois imposed the lowest tax rate, 0.5 percent, while Nevada imposed the highest tax rate, 3.5 percent. Since 1985, 22 states, including Virginia, have reduced their taxes on insurance products.

TABLE 2
Life Insurance Premium Tax Rates in the United States
Fiscal Years 1985 and 1999

State	1985 Rate	1999 Rate	Action Since 1985
Alabama	3.0	2.5	Decreased
Alaska	3.0	2.7	Decreased
Arizona	2.0	2.0	-
Arkansas	2.5	2.5	-
California	2.35	2.35	-
Colorado	2.25	2.05	Decreased
Connecticut	2.0	1.75	Decreased
Delaware	2.0	2.0	-
Florida	2.0	1.75	Decreased
Georgia	2.25	2.25	-
Hawaii	3.197	2.75	Decreased
Idaho	3.0	2.75	Decreased
Illinois	2.0	.05	Decreased
Indiana	2.0	2.0	-

4 Va. Code § 58.1-2501.
5 Va. Code § 58.1-2502.
6 House Document No. 49, 2000, *Report on the Effect of Gross Premium Tax Rates on the Attraction of Insurance Business to the Commonwealth.*

TABLE 2 (continued)

Iowa	2.0	2.0	-
Kansas	2.0	2.0	-
Kentucky	2.0	2.0[7]	Decreased
Louisiana	2.25	2.25	-
Maine	2.0	2.0	-
Maryland	2.0	2.0	-
Massachusetts	2.0	2.0	-
Michigan	2.0	EPT[8]	Decreased
Minnesota	2.0	2.0	-
Mississippi	3.0	3.0	-
Missouri	2.0	2.0	-
Montana	2.75	2.75	-
Nebraska	2.0	1.0	Decreased
Nevada	3.0	3.5	Increased
New Hampshire	2.0	2.0	-
New Jersey	2.0	2.1	Increased
New Mexico	3.0	3.0	-
New York	.08	0.7[9]	Decreased
North Carolina	2.5	1.9	Decreased
North Dakota	2.0	2.0	-
Ohio	2.5	2.3[10]	Decreased
Oklahoma	4.0	2.25	Decreased
Oregon	2.25	EPT[11]	Decreased
Pennsylvania	2.0	2.0	-
Rhode Island	2.0	2.0	-
South Carolina	3.0	0.75	Decreased
South Dakota	2.5	2.5	-
Tennessee	2.0	1.8	Decreased
Texas	2.5	1.75	Decreased
Utah	2.25	2.25	-
Vermont	2.0	2.0	-
Virginia	2.75	2.25	Decreased

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7 Beginning in 2000, there is a five-year phase-down of the premium tax on life insurance companies. At the end of the phase-down the tax rate will be 1.5 percent.

8 At one time Michigan had a premium tax but it has been replaced with a single business tax. It is estimated that the single business tax is equal to a 1.3 percent premium tax.

9 New York's premium tax is but one component of a larger state franchise tax. Also included as part of this franchise tax is an income tax. The franchise tax is capped at two percent of premiums.

10 Beginning in 1999, there is a five-year phase-down of Ohio's 2.5 percent premium tax to 1.4 percent.

11 Oregon has replaced its premium tax on out-of-state insurance companies with a corporate excise tax. A transition tax is in place for the period between 1998 and 2001.

TABLE 2 (continued)

Washington	2.16	2.0	Decreased
West Virginia	3.0	3.0	-
Wisconsin	2.0	2.0	-
Wyoming	2.5	0.75	Decreased

SOURCE: House Document No. 49, 2000, *Report on the Effect of Gross Premium Tax Rates on the Attraction of Insurance Business to the Commonwealth*.

In comparison with neighboring states, Virginia has one of the highest tax rates on insurance premiums (See Table 3). Only West Virginia has a higher tax rate on life insurance premiums, at three percent. Virginia is next at 2.25 percent, followed by Kentucky and Maryland at two percent, North Carolina at 1.9 percent, and finally Tennessee at 1.8 percent.

TABLE 3
Life Insurance Premium Tax Rates in Neighboring States
Fiscal Year 1999

State	1999 Rate
West Virginia	3.0
Virginia	2.25
Kentucky	2.0
Maryland	2.0
North Carolina	1.9
Tennessee	1.8

SOURCE: House Document No. 49, 2000, *Report on the Effect of Gross Premium Tax Rates on the Attraction of Insurance Business to the Commonwealth.*

Issues

Retaliatory Tax Credit

As of 1999, every state, except Hawaii, imposed retaliatory taxes on foreign insurance companies (companies incorporated in another state).[12] Retaliatory taxes are imposed to protect a state's domiciled insurance companies when they do business in another state.[13] As an example, Virginia domiciled insurance companies pay a three percent insurance premiums tax on policies sold in West Virginia, but West Virginia domiciled insurance companies pay only a 2.25 percent insurance premiums tax on policies sold in Virginia. To eliminate this difference in taxes, Virginia will impose a retaliatory tax of 0.75 percent on the policies sold in Virginia by West Virginia insurance companies. The end result is that both Virginia and West Virginia domiciled

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12 House Document No. 78, 1997, *Virginia's Gross Receipts Tax Imposed on Insurance Companies*.
13 *Id*.

insurance companies pay an aggregate tax of three percent on their insurance sales in the other state.

Retaliatory taxes are used to deter other states from increasing their taxes on foreign insurance companies.[14] If a state increases its insurance premiums tax on foreign insurance companies doing business in that state, it can expect that its own insurance companies will be made subject to higher retaliatory taxes on sales made in other states. If a state reduces its insurance premiums tax on foreign insurance companies, there should be a reduction in the amount of retaliatory taxes paid by its own insurance companies.

In 1998, Virginia enacted a retaliatory tax credit that reimburses Virginia domiciled insurance companies for the retaliatory taxes paid on insurance sales in other states.[15] This enables Virginia to impose a somewhat high insurance premiums tax, when compared with other states, while reducing the impact of retaliatory taxes on Virginia domiciled companies. The amount of revenue received by the Commonwealth from its insurance premiums tax more than compensates for the loss in general fund revenues attributable to the retaliatory tax credit.[16]

Revenues Dedicated to Transportation Initiatives

Beginning July 1, 2002, one-third of all insurance premium taxes will be deposited into the Priority Transportation Fund to help finance priority transportation projects (Senate Bill No. 33, House Bill No. 608, 2000). As a result, under current law, these general fund revenues cannot be used for purposes other than funding priority transportation projects.

Summary

The insurance premiums tax is the fourth largest source of general fund revenues, generating $251.1 million in fiscal year 2000. Revenues from the tax have been fairly predictable during the past 10 years, as tax revenues have increased every year since fiscal year 1992. A possible reason for this stability is that there is a strong demand for insurance products in both good and bad economic times.

Beginning July 1, 2002, one-third of insurance premium tax revenues will be dedicated to the Priority Transportation Fund to fund transportation projects. The amount of insurance premium taxes dedicated toward meeting Virginia's transportation needs may continue to be an issue for the General Assembly.

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[14] *Id*.
[15] Va. Code § 58.1-2510.
[16] House Document No. 78, 1997.

Fuels Tax

History

Motor Fuels Tax Structure and Tax Base

Comparison with Other States

Issues

Summary

Fuels Tax

History

What is now referred to as the fuels tax was originally the motor fuels and special fuels taxes. The origin of the taxes goes back to 1923, when the General Assembly first provided funds to match federal grants for highway construction (Chapter 107, *Acts of Assembly*
aviation fuel was added (Chapter 368, *Acts of Assembly*
fuels other than gasoline was added in 1940 (Chapter 307, *Acts of Assembly*
"fuel use tax" was changed to a special fuels tax in 1952 (Chapter 406, *Acts of Assembly* 1952).

In 1995, Virginia became one of the first states to follow federal law and enact

fuel in a motor vehicle on the highway except for a few limited exemptions. Fuel on which tax has been paid remains undyed and is the only fuel allowed for highway use. Since the

percent or more than $23 million annually. For the six years prior to the new dyed fuel program (FY 89-95), annual motor fuels tax collections only increased approximately 1.8

The applicable Code provisions for the motor fuels and special fuels taxes were in Article 2 (§58.1-2104 et seq.) and Article 3 (§58.1-2115 et seq.) of Chapter 21 of Title 58.1. During the 2000 General Assembly Session those two articles were repealed and replaced with Chapter 22 (§58.1-2200 et seq.) of Title 58.1 (Chapters 729 and 758, *Acts of Assembly*, 2000) at the urging of the Department of Motor Vehicles (DMV), which administers the tax. This new chapter is known as the Virginia Fuels Tax Act.

Fuels Tax Structure and Tax Base

Effective January 1, 2001, the Virginia fuels tax system changed significantly. Under the prior system, fuel could be purchased and sold numerous times before the fuels tax was collected. This made tracking the fuel for tax purposes very difficult and led to uncollected revenues due to an intricate trail of exchanges, according to DMV.

Under the new system, fuels tax is paid at the terminal rack before it circulates to licensed distributors. The terminal rack is the point at which fuels physically leave a terminal and are deposited into a tank truck, rail car or other means of transportation to begin the distribution process. Suppliers pay the tax to DMV. Known as "tax at the rack," the new system is expected to reduce the number of entities submitting fuels taxes from 1,300 to around 200.[1]

There are two exceptions to the "tax at the rack" rule: (i) when fuels are imported into Virginia by means other than through terminals, and (ii) when fuels are blended in Virginia outside the terminal system. In these cases, the tax is assessed when imported or blended.

Businesses that operate at the terminal rack (i.e. suppliers) or serve as importers (i.e. bonded importers) must obtain a license from and remit the taxes to DMV. A supplier is a person who (1) is a position holder (i.e. major oil companies), (2) receives motor fuels through a two-party exchange, or (3) is a fuels alcohol provider. Because fewer businesses are responsible for remitting the tax, fewer businesses are required to obtain licenses and file bonds.

Bonding under the new system is less complicated than it was under the old one. Rather than thousands of businesses having multiple bonds, far fewer businesses are required to file just one bond.

There are two levels of bonds under the "tax at the rack" system. The higher liability bond is a $2,000,000 bond that must be filed by suppliers, terminal operators and bonded importers.[2] The lower liability bond is a bond of three times the average expected monthly tax liability (determined by DMV), not less than $2,000 nor more than $300,000.[3]

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[1] *Electronic Fuels Tax Collection (Point of Taxation for Motor Fuels)*, Richard D. Holcomb, Commissioner, Virginia Department of Motor Vehicles, February 2000.
[2] Va. Code § 58.1-2211 A 1 (2000).
[3] Va. Code § 58.1-2211 A 2 (2000).

Those required to file such a bond are fuels alcohol providers, occasional importers, distributors, blenders, aviation consumers, alternative fuels providers, alternative fuels retailers, alternative fuels bulk users and any combination of the preceding.[4]

None of the fuel tax rates changed with the enactment of the Virginia Fuels Tax Act. The motor fuel tax rates are as follows:

1. Seventeen and one-half cents per gallon on gasoline, gasohol and blended fuel containing gasoline;

2. Sixteen cents per gallon on diesel fuel and blended fuel containing diesel fuel;

3. Five cents per gallon on aviation gasoline; however, the rate is seventeen and one-half cents per gallon on aviation fuel used in highway vehicles;

4. Five cents per gallon on aviation jet fuel purchased or acquired for use by a user of aviation fuel other than an aviation consumer;

5. Five cents per gallon on the first 100,000 gallons of aviation jet fuel, excluding bonded aviation jet fuel, purchased or acquired for use by any aviation consumer in a fiscal year and one-half cent per gallon on such aviation jet fuel in excess of 100,000 gallons in a fiscal year; and

6. Sixteen cents per gallon on aviation jet fuel used in highway vehicles.[5]

The alternative fuel tax rates are as follows:

1. Sixteen cents per gallon on liquid alternative fuel used to operate a highway vehicle by means of a vehicle supply tank that stores fuel only for the purpose of supplying fuel to operate the vehicle; and

2. Sixteen cents per gallon on all other alternative fuel used to operate a highway vehicle.[6]

Motor fuel is defined as gasoline, diesel fuel, blended fuel, and aviation fuel.[7] Alternative fuel is defined as combustible gas, liquid or other energy source, that is not motor fuel, used to generate power to operate a highway vehicle.[8]

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[4] *Id*.
[5] Va. Code § 58.1-2217 (2000).
[6] Va. Code § 58.1-2249 (2000).
[7] Va. Code § 58.1-2201 (2000).
[8] Va. Code § 58.1-2201 (2000).

The tax is due to DMV on the 20th day of the second month after the transaction.[9] Payments may be made through electronic reporting options and the use of electronic funds transfers.

There are tax-exemptions provided for federal, state and local governments and certain nonprofit charitable organizations.[10] DMV estimates that the Commonwealth will realize approximately three percent, or around $20 million, in additional annual revenue as a result of the "tax at the rack." Table 1 shows the motor fuels tax collections for the past 10 years. Except for 1991 and 1995, the collections have grown each year.

TABLE 1
Fuels Tax
Fiscal Years 1991-2000

Fiscal Year Ending June 30	Tax Collections	% Increase/ Decrease from Previous Year
1991	$616,722,000	-0.01
1992	625,196,000	+1.4
1993	642,643,000	+2.8
1994	678,197,000	+5.5
1995	671,484,000	-0.01
1996	706,083,000	+5.2
1997	713,939,000	+1.1
1998	750,225,000	+5.1
1999	771,572,000	+2.8
2000	784,434,000	+1.7

There is a one-time tax necessitated by the fact that many companies will have floorstock that needs to be reported. Floorstock is the untaxed fuels held in inventory at the close of business on December 31, 2000. Any businesses having floorstock on that date will be responsible for the tax, which must be paid to DMV by June 30, 2001, although floorstock inventory reports are due no later than February 1, 2001.[11]

The floorstock tax on motor fuel is equal to the sum of (i) the tax rate specified by § 58.1-2217 for the type of fuel and (ii) the storage tank fee rate specified under § 62.1-44.34:13, multiplied by the gallons in storage as of the close of the business day preceding January 1, 2001.[12]

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[9] Va. Code § 58.1-2230 (2000).
[10] Va. Code § 58.1-2226 and 58.1-2250 (2000).
[11] Va. Code § 58.1-2290 (2000).
[12] Va. Code § 58.1-2290 A. (2000).

The floorstock tax on alternative fuel will be the tax rate specified in subsection A of §58.1-2249, multiplied by the gallons in storage as of the close of the business day preceding January 1, 2001.[13]

If the tax is paid on or before February 1, 2001, the business paying the tax will receive a 10 percent discount on the total amount due.[14] Any fuel in dead storage, which is fuel that will not be pumped out because it is below the draw pipe of the tank, may be excluded in determining the amount of floorstock tax.[15]

Enforcement and administration of the fuels tax lies in the hands of DMV. Suppliers who are required to pay taxes to DMV must submit tax reports while all other licensees may be required to submit fuels activity reports.[16] Such reports may be filed electronically through the Internet or through hard copy (i.e. paper forms).

Comparison with Other States

At the time of the enactment of the "tax at the rack" legislation, there were 19 other states that collect fuels tax in this same manner.[17] Those 19 states are Arizona, California, Florida, Iowa, Idaho, Indiana, Kansas, Michigan, Minnesota, Missouri, North Carolina, Oklahoma, South Carolina, South Dakota, Tennessee, Utah, Washington, Wisconsin and Wyoming.

Of the 19 states only two, Kansas and Wyoming, have no bond requirements and only two, Indiana and Kansas, have no floorstock tax.[18] According to DMV, the states that have enacted the "tax at the rack" system have reported having good results with collections and administration.

Every state has some type of fuel excise taxes, whether collected at the rack or in some other manner. Table 2 provides a comparison of each state's excise tax on gasoline and diesel fuel.

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[13] *Id*.
[14] Va. Code § 58.1-2290 B. (2000).
[15] Va. Code § 58.1-2290 C. (2000).
[16] See Article 4 (§ 58.1-2230 et seq.) of Title 58.1 (2000).
[17] *Electronic Fuels Tax Collection (Point of Taxation for Motor Fuels),* Richard D. Holcomb, Commissioner, Virginia Department of Motor Vehicles, February 2000.
[18] *Innovative Progress: Transportation Initiative, Electronic Fuels Tax Collection*, Tab 7, Department of Motor Vehicles, January 2000.

Table 2
Motor Fuels Tax Rates

State	Gasoline Cents per gallon	Diesel Fuel Cents per gallon
Alabama	16.0	17.0
Alaska	8.0	8.0
Arizona	18.0	18.0
Arkansas	19.5	20.5
California	18.0	18.0
Colorado	22.0	20.5
Connecticut	32.0	18.0
Delaware	23.0	22.0
Florida	4.0	16.1
Georgia	7.5	7.5
Hawaii*	16.0	16.0
Idaho	25.0	25.0
Illinois*	19.0	21.5
Indiana	15.0	16.0
Iowa	20.0	22.5
Kansas	20.0	22.0
Kentucky	15.0	12.0
Louisiana	20.0	20.0
Maine	22.0	23.0
Maryland	23.5	24.25
Massachusetts	21.0	21.0
Michigan	19.0	15.0
Minnesota	20.0	20.0
Mississippi	18.0	18.0
Missouri	17.0	17.0
Montana	27.0	27.75
Nebraska	23.9	23.9
Nevada*	24.0	27.0
New Hampshire	18.0	18.0
New Jersey	10.5	13.5
New Mexico	17.0	18.0
New York	8.0	8.0
North Carolina	22.0	22.0
North Dakota	21.0	21.0
Ohio	22.0	22.0
Oklahoma	16.0	13.0
Oregon*	24.0	24.0
Pennsylvania	12.0	12.0
Rhode Island	28.0	28.0
South Carolina	16.0	16.0

Table 2 (Continued)

South Dakota*	22.0	22.0
Tennessee*	20.0	17.0
Texas	20.0	20.0
Utah	24.5	24.5
Vermont	19.0	16.0
Virginia*	17.5	16.0
Washington	23.0	23.0
West Virginia	20.5	20.5
Wisconsin	25.8	25.8
Wyoming	13.0	13.0
Dist. of Columbia	20.0	20.0
Federal	18.3	24.3

* Tax rates do not include local option taxes.
SOURCE: Federal Tax Administrators, 2000.

Issues

Anytime there is a major change in the law, there are unforeseen problems that arise, in spite of efforts made to think of and plan for every consequence and contingency. It may involve some aspect of the law's administration or how best to disseminate the information to everyone who is affected by the change. DMV has worked hard in preparing and offering written materials explaining the new law as well as presenting seminars throughout the Commonwealth.

Until "tax at the rack" has been in effect for several years, no one really knows what issues may arise.

Summary

The Commonwealth's fuels tax system underwent significant changes during the 2000 Session of the General Assembly. Instead of a system in which fuel was purchased and sold several times before any fuels tax was collected, the new system requires the fuels tax to be levied and paid at the terminal rack before it is distributed to licensed distributors. This new method is known as "tax at the rack."

In addition to the tax being paid and, thereby, collected sooner, it is believed there will be less fraud due to the fewer entities collecting and remitting fuels tax to DMV. In addition, fewer entities will be required to file a bond and any entity filing a bond will only be required to file one.

While the "tax at the rack" system is an overhaul of much of the administrative portion of the Commonwealth's fuels taxes, the fuels tax rates did not change at all. In adopting the "tax at the rack" method for collecting fuels taxes, Virginia became the 20th state to do so.

Virginia's Motor Vehicle Titling Tax

History

Tax Administration

Tax Rate

Issues

Summary

Virginia's Motor Vehicle Titling Tax

History

Virginia adopted its Motor Vehicle Sales and Use Tax in 1966 when it imposed a two percent tax on the sale or use of motor vehicles in Virginia.[1] The tax became effective September 1, 1966. The Motor Vehicle Sales and Use Tax, generally known as the Titling Tax, was imposed at the same rate and the same time that Virginia adopted its Virginia Retail Sales and Use Tax. The two percent titling tax rate was unchanged until the 1986 Special Session on Transportation increased the Titling Tax to the current three percent rate.[2]

The Commonwealth relies on the Titling tax as an important component of financing the transportation infrastructure of Virginia. Table 1 shows Virginia's titling tax collections during the past 10 years. For the latest fiscal year ending June 30, 2000, the Commonwealth collected slightly in excess of $498 million from the Titling Tax. A review of the titling tax collections during the past 10 years shows a great deal of variation. Of course, titling tax collections are based on the sales of new and use motor vehicles, which are dependent on economic activity as well as the price of motor vehicles. Titling tax collections actually declined by 11.1

[1] 1966 Acts of Assembly, Chapter 587.
[2] 1986 Special Session Acts of Assembly, Chapter 11.

percent in fiscal year 1990-91 when the United States was still in its most recent recession. During the mid 1990s when the economy came out of its recession, increases in titling tax have been in the double digit range. The past two fiscal years have also seen increases in excess of 10 percent annually.

TABLE 1
Motor Vehicle Titling Tax Collections
Fiscal Years 1991- 2000

Fiscal Year Ending June 30	Collections	% Change from Previous Year
1991	$230,381,000	-11.1
1992	238,379,000	+3.5
1993	266,577,000	+11.8
1994	324,599,000	+21.8
1995	357,875,000	+10.3
1996	375,043,000	+4.8
1997	389,178,000	+3.8
1998	399,269,000	+2.6
1999	441,586,000	+10.6
2000	498,098,000	+12.8

Tax Administration

The Titling Tax is administered by the Department of Motor Vehicles (DMV). The tax is paid by the purchaser of the motor vehicle at the time the purchaser applies to DMV for a Certificate of Title. The tax is based on the pricing information, which is required by law to be posted on the motor vehicle. However, if the actual price paid is less than the posted price, that amount is used in the computation of the titling tax. There is no allowance for a trade-in in Virginia. There is an exemption from the titling tax for motor vehicles used for rental purposes. However, a four percent rental tax is imposed on the person renting the motor vehicle, with the tax being remitted to the Department of Motor Vehicles by the 20th of the following month.

There are a number of exemptions under the Titling Tax such as one for motor vehicles titled in Virginia for the first time where the titling tax has already been paid to another state. Another exemption is provided for motor vehicles that are given as gifts to a spouse or to a child.

TABLE 2
State Titling Tax
Rates on Motor Vehicles, January, 2001

State	Tax Rate	Credit for Trade-in
Alabama	2%	yes
Alaska	none	--
Arizona	5%	yes
Arkansas	4.625% (exempt if below $2,500)	yes
California	7.25%	no
Colorado	2.9%	yes
Connecticut	6% on book value	yes
Delaware	2.75%	yes
Florida	6%	yes
Georgia	4%	yes
Hawaii	4%	no
Idaho	5%	yes
Illinois	6.25%	yes
Indiana	5%	yes
Iowa	5%	yes
Kansas	4.9%	yes
Kentucky	6%	no
Louisiana	4%	yes
Maine	5%	yes
Maryland	5%	no
Massachusetts	5%	yes
Michigan	6%	no
Minnesota	6.5%	yes
Mississippi	5.0%	yes
Missouri	4.225%	yes
Montana	1-1/2% on factory list price	no
Nebraska	5%	yes
Nevada	6.5%	yes
New Hampshire	1.8% on list price, declines for older vehicles	no
New Jersey	6%	yes
New Mexico	3%	yes
New York	4%	yes
North Carolina	3% ($1,500 max)	yes
North Dakota	5%	yes
Ohio	5%	yes
Oklahoma	3.25%	yes
Oregon	none	--
Pennsylvania	6%	yes
Rhode Island	7%	yes
South Carolina	5% ($300 max)	yes
South Dakota	3%	yes
Tennessee	6%	yes

TABLE 2 (CONTINUED)

Texas	6.25%	yes
Utah	5.875%	yes
Vermont	6%	yes
Virginia	3% - 1-1/2% clean fuel ($35 minimum)	no
Washington	6.5%	yes
West Virginia	5%	yes
Wisconsin	5%	yes
Wyoming	4%	yes

SOURCE: *N.A.D.A. Title and Registration Text Book,* 2001 Edition; NADA Appraisal Guides, Inc.

Tax Rate

Table 2 provides a listing of state titling tax rates in other states. Virginia's titling tax rate of three percent compares very favorably with the other states. Only seven states impose a lower state rate than does Virginia. In addition, in a number of other states localities are allowed to impose a local titling tax. There are 15 states with a titling tax rate of six percent or higher. The highest tax rate is imposed by the state of California, which imposes a titling tax rate of 7.25 percent. For the vast majority of states the tax is imposed on the selling price of the motor vehicle although a few states base the tax on the list price of the motor vehicle.

The burden of the titling tax rates is mitigated by most states, which allow a deduction from the base of the value of the trade in. Virginia is one of only eight states that doesnot allow a deduction for the value of the trade in. Two states attempt to reduce the tax on high-value vehicles by imposing a maximum titling tax. South Carolina imposes a maximum titling tax of $300. Arkansas exempts from the titling tax vehicles that sell for less than $2,500.

In terms of surrounding states, Virginia's titling tax is below those of our neighboring states with the exception of North Carolina. North Carolina imposes the same three percent tax rate but allows a deduction for the value of the trade-in. The deduction for a trade-in that most states provide is an effort to not penalize taxpayers who frequently trade in vehicles.

Issues

Deduction of Trade in

As previously noted, the titling tax was enacted at the same time as the Virginia Retail Sales and Use Tax in 1966. The sales prices is defined under the Retail Sales and Use Tax as excluding from the price the value of used articles that are taken in trade. Although Virginia's titling tax does not allow this deduction for a trade-in, the vast majority of other states do provide a deduction for the trade-in.

The deduction for a trade-in is an attempt to reduce the tax burden on those individuals and businesses that frequently trade in their vehicles for newer models.

Summary

Virginia's Titling tax generates almost $500 million annually to help Virginia fund its transportation program. The tax is imposed on the sale of motor vehicles in Virginia and is levied at a three percent rate on the selling price of the motor vehicle. Collections are largely dependent on the level of economic activity because the state of the economy is a prime factor in determining motor vehicle sales.

Virginia's titling tax rate is relatively low compared to other states, however, the Commonwealth is one of only eight states that does not reduce the tax by the value of a trade-in.